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Questions within the Workbook should be treated as preparation questions, providing you with a firm foundation before you attempt the exam-standard questions. The exam-standard questions are found in the Question Bank.

Chapter 1



Financial instruments: hedge accounting

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Introduction

Learning outcomes

- Show, explain and appraise hedge accounting principles and procedures in accordance with IAS 39 and IFRS 9, including appropriate calculations.

The specific syllabus reference for this chapter is 3(e).

Syllabus links

Financial Accounting and Reporting

LO 2(a) identify the laws and regulations, and accounting standards and other requirements applicable to the statutory financial statements of an entity

LO 2(b) calculate from financial and other data the amounts to be included in an entity's financial statements according to the international financial reporting framework

LO 2(c) prepare and present the financial statements, or extracts, of an entity in accordance with its accounting policies and appropriate international financial reporting standards

LO 2(d) explain the application of IFRS to specified single entity scenarios

LO 3(d) calculate from financial and other data the amounts to be included in an entity's consolidated financial statements in respect of its new, continuing and discontinued interests in subsidiaries, associates and joint ventures (excluding partial disposals of subsidiaries and disposals of associates or joint ventures) according to the international financial reporting framework

LO 3(e) prepare and present the consolidated financial statements, or extracts, of an entity in accordance with its accounting policies and appropriate international financial reporting standards

LO 3(f) explain the application of IFRS to specified group scenarios

Although certain aspects of IFRS 9 are covered in this module, its provisions in relation to hedge accounting were not.

Examination context

This chapter covers the purpose and practice of hedge accounting from the perspective of banks.

It is necessary to understand both the IAS 39 and IFRS 9 rules on hedging as banks have a choice regarding which to apply.

In the Business Planning: Banking examination IFRS 9 should be applied unless candidates are told otherwise.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	Hedge accounting policy choice Banks use financial instruments for hedging to manage the risks that they face. This leads to a need to understand the requirements and	Approach Ensure that you make full use of the examples provided in this chapter. As you work through the chapter focus on the differences between	When dealing with hedging transactions in the examination you could be asked for either IAS 39 or IFRS 9 rules so you must be able to use both standards.	None required.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	<p>practice of hedge accounting.</p> <p>There is an accounting policy choice to use IAS 39 and/or IFRS 9 rules for hedging. The standards provide the qualifying criteria for determining when the choice of hedge accounting is available and specify permissible hedging instruments and hedged items.</p> <p>Both IAS 39 and IFRS 9 classify hedges into one of three different types: fair value hedge; cash flow hedge; and hedge of a net investment.</p>	<p>the three different types of hedge and the different accounting treatments applicable.</p> <p>Stop and think</p> <p>What is the reasoning behind permitting hedge accounting?</p>	<p>IFRS 9 hedging rules are becoming more important as the IAS 39 hedge accounting policy choice is expected to be phased out in the near future.</p>	
2	<p>Overview of IAS 39 hedge accounting</p> <p>Examples of hedging transactions are a common feature of banking activity as a consequence of firms seeking to manage the risks in their balance sheet and their income streams.</p> <p>It is important to understand the criteria which determine when hedge accounting is available and to understand the accounting treatment in relation to the three different types of hedge under IAS 39 and IFRS 9.</p>	<p>Approach</p> <p>See topic 1.</p> <p>Stop and think</p> <p>Which type of hedge is required in different circumstances?</p>	See topic 1.	None required.
3	<p>Fair value hedge</p> <p>You must determine when fair value hedge accounting rules are required in a scenario.</p>	<p>Approach</p> <p>See topic 1.</p> <p>Stop and think</p> <p>See topic 1.</p>	See topic 1.	<p>IQ1</p> <p>This question introduces the fair value hedge.</p>
4	<p>Cash flow hedge</p> <p>You must determine when cash flow hedge accounting rules are required in a scenario.</p>	<p>Approach</p> <p>See topic 1.</p> <p>Stop and think</p> <p>See topic 1.</p>	See topic 1.	<p>IQ3</p> <p>This question introduces the cash flow hedge.</p>

Topic	Practical significance	Study approach	Exam approach	Interactive questions
5	Hedge of a net investment This type of hedge is very specific to one scenario where you wish to protect against foreign currency exposure of a foreign operation.	Approach See topic 1. Stop and think See topic 1.	An awareness of this type of hedge is required.	None required.
6	Summary of hedge accounting This table provides a useful reminder of the three types of hedge.	Approach See topic 1. Stop and think See topic 1.	See topic 1.	None required.
7	Hedged items There can be some uncertainty about what constitutes a hedged item. For example, the hedge of a group of assets or hedging a net position.	Approach See topic 1. Stop and think See topic 1.	See topic 1.	None required.
8	Hedging instruments Derivatives are used to protect the hedged item.	Approach See topic 1. Stop and think See topic 1.	See topic 1.	IQ4 This question uses an interest rate swap as the hedging instrument.
9	Conditions for hedge accounting Certain criteria must be met for hedge accounting to be allowed.	Approach See topic 1. Stop and think See topic 1.	See topic 1.	None required.
10	IFRS 9 changes in hedge accounting This is an important topic to understand the new rules on hedge accounting.	Approach There are many similarities between IAS 39 and IFRS 9 hedge accounting but make sure you understand the differences. Stop and think What is the IASB trying to achieve with the IFRS 9 hedging criteria?	See topic 1.	IQ5 This question outlines the treatment under IAS 39 and IFRS 9 hedging rules.
11	Impact of LIBOR reform	Approach	See topic 1.	None required.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	This topic explains the impact of LIBOR reform on hedge accounting.	You need to have an awareness of the changes that are being introduced. Stop and think Do you know why LIBOR and similar benchmarks are being replaced?		

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Hedge accounting policy choice



Section overview

- This section explains the accounting policy choice for hedge accounting.
 - Entities may apply the new IFRS 9 rules in their entirety or entities may apply the hedge accounting rules of IAS 39 to all of its hedging relationships while following the classification and measurement rules of IFRS 9.
 - Entities undertaking macro hedging activities may apply the new general hedge accounting model in IFRS 9 while continuing to apply the specific macro hedging requirements of IAS 39.
 - The IASB is working on its dynamic risk management project and intends to publish a discussion paper in 2019.
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2.1 IAS 39 and IFRS 9

IFRS 9, *Financial Instruments* became effective for accounting periods beginning on or after 1 January 2018. The International Accounting Standards Board (IASB) continues to work on its project to deal with macro hedging or 'dynamic risk management' and to replace IAS 39 rules on hedging entirely.

Currently, when an entity first applies IFRS 9, it may choose as its **accounting policy** to apply the new IFRS 9 rules in their entirety or it may choose to continue to apply the hedge accounting requirements of IAS 39 instead of the hedging requirements in IFRS 9. The accounting policy choice is applied to all of its hedging relationships.

Entities undertaking macro hedging activities can apply the new general hedge accounting model in IFRS 9 while continuing to apply the specific macro hedging requirements of IAS 39.

Financial institutions often use a **macro-hedging strategy** to manage their interest rate risk exposure of a portfolio of financial assets and liabilities eg, hedging the net position of fixed rate financial assets and fixed rate financial liabilities. Under a macro-hedging model, the amounts of both the hedging instrument and the hedged item change constantly.

These options are available until the IASB has completed its ongoing project on macro hedging. The IASB plans to do outreach on its core model to gather stakeholders' views in the second half of 2020.

This chapter begins with the IAS 39 rules and continues to cover the changes introduced by IFRS 9.

3 Overview of IAS 39 hedge accounting



Section overview

- This section contains the key points to obtain a basic overview of hedge accounting.
 - Hedge accounting aims to reflect the risk management activities of an entity in its financial statements.
 - Hedge accounting is optional however if an entity chooses to apply hedge accounting the requirements of IAS 39 and/or IFRS 9 must be followed.
 - The entity that applies hedge accounting must document and designate the hedging relationship. An ongoing assessment of hedge effectiveness is required.
 - There are three types of hedges – fair value hedge, cash flow hedge and hedge of a net investment in a foreign operation.
-

4.1 Introduction

An entity may enter into transactions to **reduce risks such as changes in fair value or variability of cash flows**. These risks could relate to items already recognised on the statement of financial position or future transactions that are yet to occur.

As an example, a bank may enter into a pay fixed, receive floating interest rate swap to manage the risk of decreases in the fair value of a fixed rate loan originated by the bank. The interest rate swap is a derivative that converts the fixed rate exposure to floating rate. If interest rates increase, the decrease in fair value of the loan will be offset by the increase in fair value of the interest rate swap. The **interest rate swap** is a **hedging instrument**, while the **fixed rate loan** is the **hedged item**.

A bank which has originated a floating rate loan may enter into a pay floating, receive fixed interest rate swap to reduce the variability in cash flows of the floating rate loan.

It is possible to hedge future transactions that are yet to occur. A construction company may enter into a forward contract to purchase steel at a price that is agreed today but settled in the future on delivery. The forward price specified in the forward contract may be higher or lower than the spot price at the time the contract is agreed, depending on seasonal and other factors. By entering into the forward contract both the construction company and producer of steel have removed the risk they otherwise would face of unfavourable price movements (spot price increases being unfavourable to the construction company and spot price decreases unfavourable to steel producer) between now and the physical delivery date. Equally, they have removed the possibility of favourable price movements (spot price decreases being favourable to the construction company and spot price increases favourable to the steel producer) over the period. The **future purchase of steel** is the **hedged item**, while the **forward contract** is the **hedging instrument**.

Hedge accounting is an accounting process which **reflects in financial statements the commercial substance of hedging activities**. It results in the gains and losses on the linked items (eg, the purchase of steel and the forward market transactions) being recognised in the same accounting period and in the same section of the statement of profit or loss or other comprehensive income. Hedge accounting reduces or eliminates the volatility in profit or loss which would arise if the items were not linked for accounting purposes.



Professional skills focus: Structuring problems and solutions

It is important to distinguish between the commercial purposes of hedging to reduce risk and the financial reporting impact of hedging. The financial reporting rules for hedge accounting allow transactions to be presented in the same statement at the same time. You may need to suggest the most appropriate solution for a bank which meets its objectives.

Notes

The forward contract is a derivative. Without hedge accounting, the profit/(loss) on the forward contract would be recognised as the contract is re-measured to fair value at each reporting date, but the increase/(decrease) in cost of the steel would be recognised at the later date when the delivery takes place. Both would be recognised in profit or loss, but possibly in different accounting periods.

Financial assets should be classified/designated at the time of their initial recognition, not at any later date. This is to prevent entities making classifications/designations with the benefit of hindsight so as to present figures to their best advantage. Similarly, hedge accounting is only permitted by IAS 39 if the **hedging relationship** between the two items (purchase of steel and the forward contract in the above example) is **designated at inception** of the hedge. There must also be a **formal documentation**, both of the hedging relationship and of management's objective in undertaking the hedge.

Hedge accounting is an **accounting policy choice**, not a requirement. If an entity does not wish to use hedge accounting, it may choose not to apply it. If the hedging relationship does not meet IAS 39 conditions (eg, it is not properly documented), then hedge accounting is not permitted. Some entities take the view that the costs of meeting these conditions outweigh the benefits of hedge accounting and choose not to adopt hedge accounting.

If an entity chooses to apply the IAS 39 treatment for hedge accounting, then the hedge accounting requirements of this standard become compulsory.

4.2 Overview

The main components of hedge accounting are summarised below:

- The **hedged item** is a recognised asset or liability, a firm commitment (a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date) or a forecast transaction (an uncommitted but anticipated future transaction that is highly probable such as the issue in three months' time of fixed rate debt) which exposes the entity to risks of fair value/cash flow changes. The hedged item generates the risk which is being hedged.
- The **hedging instrument** is a derivative or other financial instrument whose fair value/cash flow changes are expected to offset those of the hedged item. The hedging instrument reduces/eliminates the risk associated with the hedged item.
- There is a **designated relationship** between the hedged item and the hedging instrument which is documented.
- At inception, the hedge must be expected to be **highly effective** and effectiveness must be monitored over the life of the relationship.
- To qualify for hedging, the changes in fair value/cash flows must have the potential to affect profit or loss.
- There are three types of hedges in IAS 39:
 - **Fair value hedge:** It is the hedge of the **exposure to changes in fair value** of a recognised asset or liability or unrecognised firm commitment that could affect profit or loss. The gains and losses on such a hedge are recognised in profit or loss.

For example, **fixed rate financial assets and liabilities** have fair value exposure to changes in market rates of interest and credit quality. **Non-financial assets** like commodities have fair value exposure to changes in their market price.

- **Cash flow hedge:** It is the hedge of the **exposure to variability in cash flows** that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction, and could affect profit or loss. The effective portion of gains and losses on such a hedge are initially recognised in other comprehensive income and subsequently reclassified to profit or loss.

For example, **variable rate financial assets and liabilities** are exposed to variability in the cash flows and may be hedged through floating to fixed interest rate swap. Highly probable forecast expenses and revenues in foreign currency are exposed to variability in cash flows and may be hedged through a forward contract.
- **Net investment hedge:** It is the hedge of the foreign currency exposure to changes in the entity's share in the net assets of a foreign operation. The designated hedged risk is the translation of the net assets of the foreign operation into the parent's functional currency. The effective portion of gains and losses on such a hedge are initially recognised in other comprehensive income and subsequently reclassified to profit or loss (same accounting treatment as cash flow hedge).

The **fair value** and **cash flow** hedges are **common types of hedges**. In some circumstances the entity can choose whether to classify a hedge as a fair value or a cash flow hedge.

The **hedge of a net investment** in a foreign operation is **only permitted in consolidated financial statements** where the net assets of the foreign operation are recognised.

The above three types of hedges are discussed in more detail with examples in later part of this chapter.

4.3 Effectiveness of the hedge

The hedge effectiveness is measured as the extent to which change in fair value of the hedging instrument offsets change in fair value of the hedged item.

- If the loss on the hedged item is £100 and the gain on the hedging instrument is £100, the hedge is fully effective.
- If the loss on the hedged item is £100 and the gain on the hedging instrument is £90, the hedge is not fully effective. Its effectiveness can be measured as $100/90 = 111\%$ or as $90/100 = 90\%$.
- Hedge accounting is only permitted if, both at inception and during the life of the hedging relationship, the measure of effectiveness falls between 80% and 125%.

5 Fair value hedge



Section overview

- A fair value hedge reduces an entity's exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment.
- In a fair value hedge, the gain or loss on the hedged item and hedging instrument is recognised in profit or loss. The hedge ineffectiveness, if any, is therefore also recognised in profit or loss.
- If only a portion of the risks attributable to the hedged item are included in the hedging relationship, the fair value movements attributable to risks that are not a part of the hedging relationship is recognised in profit or loss.
- An entity can apply fair value hedge accounting to a portfolio of financial assets and/or financial liabilities for interest rate risk only.
- Fair value hedge accounting is discontinued in certain circumstances and such discontinuation should be accounted for prospectively.

6.1 Overview of fair value hedging

A fair value hedge is a hedge of an entity's exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a part thereof that is attributable to a particular risk and could affect profit or loss.

6.1.1 Examples of fair value hedging

Hedged item	Risk exposure	Type of risk	Example of hedging instrument
Originated fixed rate loan	Change in the value of the loan as interest rates change	Market risk (interest rate risk)	Interest rate swap
Issued fixed rate bond	Change in the value of the bond as interest rates change	Market risk (interest rate risk)	Interest rate swap
Purchased equities	Change in the value of the investments due to changes in the price of equity	Market risk (price risk)	Purchase put option
Firm commitment entered into to purchase a non-current asset denominated in foreign currency in three months' time	Depreciation of the local currency and increase in the cost of non-current asset	Market risk (price and foreign currency)	Forward contract

6.1.2 Hedge accounting and risk reduction

IAS 39 does not require that in order for a hedging relationship to qualify for hedge accounting, it should lead to a reduction in the overall risk of the entity. A hedging relationship that satisfies the conditions for hedge accounting may be designed to protect the value of a particular asset. The following example illustrates the point.



Worked example: Qualification for hedge accounting

An entity has a fixed rate financial asset and a fixed rate financial liability, each having the same principal amount. Under the terms of the instruments, interest payments on the asset and liability occur in the same period and the net cash flow is always positive because the interest rate on the asset exceeds the interest rate on the liability. The entity wishes to hedge the financial asset and enters into an interest rate swap to receive a floating interest rate and pay a fixed interest rate on a notional amount equal to the principal of the asset. It designates the interest rate swap as a fair value hedge of the fixed rate asset.

Requirement

Does the hedging relationship qualify for hedge accounting even though the effect of the interest rate swap on an entity-wide basis is to create an exposure to interest rate changes that did not previously exist?

Solution

Yes. IAS 39 does not require risk reduction on an entity-wide basis as a condition for hedge accounting. Exposure is assessed on a transaction basis and, in this instance, the asset being hedged has a fair value exposure* to interest rate increases that is offset by the interest rate swap.

*The fair value of a loan is the present value of the cash flows. A fixed rate loan has constant cash flows so the fair value is directly affected by a change in the discount rate (ie, the market interest rate).

6.2 Fair value hedge accounting

If a fair value hedge meets the conditions for hedge accounting during the period, it should be accounted for as follows:

- The **gain or loss** from remeasuring the **hedging instrument at fair value** should be **recognised in profit or loss**; and
- The **gain or loss on the hedged item** attributable to the hedged risk adjusts the carrying amount of the hedged item and is **recognised in profit or loss**.

It is normal for **gains and losses on derivatives** to be **recognised in profit or loss**, so those designated as hedging instruments does not affect the accounting treatment. However, the **gains and losses** on the **hedged items** may not normally be **recognised in profit or loss**. For example, if the hedged item is a financial asset, say a debt instrument measured at fair value through other comprehensive income, the gain or loss attributable to the risk being hedged should be recognised in profit or loss, rather than in other comprehensive income. But the remainder of any fair value change should still be recognised in other comprehensive income.

As the gains or losses on both the hedged item and the hedging instrument are recognised in profit or loss, any **ineffectiveness is also recognised in profit or loss**. However, the hedge should still be checked for being highly effective. If the hedge is not highly effective, hedge accounting is not allowed and there will be no change to the carrying amount of what was previously the hedged item, and only the gain or loss on what was previously the hedging instrument will be recognised in profit or loss.



Worked example: Fixed rate loan

At 1 January 20X5, Max Bank purchased loan notes of £100 million at fixed interest rate of 6% for three years. The bank believes that interest rates are likely to increase, and enters into an interest rate swap contract with notional principal of £100 million, three-year term. Under the swap contract, the bank pays fixed interest payments based on 6% at the end of each year and receives at the end of each year market interest rate at beginning of the year.

Max Bank has designated this as a fair value hedge. The market interest rate is 6% on 1 January 20X5, 5.5% on 31 December 20X5 and 6.25% on 31 December 20X6. The fair values of the loan notes and interest rate swap is as follows:

Amounts in £	31 December 20X7	31 December 20X6	31 December 20X5
Fair value of loan notes before redemption	100,000,000 asset	99,764,706 asset	100,923,160 asset
Fair value of interest rate swap	-	235,294 asset	(923,160) liability

Requirement

Prepare journal entries for 20X5, 20X6 and 20X7 in respect of this transaction and show extracts of the statement of profit or loss and the statement of financial position at the end of each year.

Solution

The journal entries required are as follows.

1 January 20X5

DEBIT Loan asset	£100,000,000	
CREDIT Cash		£100,000,000
(Purchase of loan notes)		

31 December 20X5

DEBIT Cash	£6,000,000	
CREDIT Interest income		£6,000,000
(Interest on loan at 6% fixed on £100m)		
DEBIT Loan asset – fair value adjustment	£923,160	
CREDIT Fair value gain on loan		£923,160
(Fair value gain on fixed rate loan due to fall in market interest rates)		
DEBIT Fair value loss – interest rate swap	£923,160	
CREDIT Derivative liabilities		£923,160
(Loss in fair value of interest rate swap)		

No net interest is settled on the swap as the fixed and market rates are the same.

31 December 20X6

DEBIT Cash	£6,000,000	
CREDIT Interest income		£6,000,000
(Interest on loan at 6% fixed on £100m)		
DEBIT Interest income/expense	£500,000	
CREDIT Cash		£500,000
(Net interest paid on the swap at 6% – 5.5% = 0.5% of £100m)		
DEBIT Fair value loss – loan asset	£1,158,454	
CREDIT Loan asset – fair value adjustment		£1,158,454
(Loss in fair value of loan asset due to increase in market interest rate)		
DEBIT Derivative liabilities	£923,160	
DEBIT Derivative assets	£235,294	

CREDIT Fair value gain – interest rate swap £1,158,454
(Fair value gain on interest rate swap – it is an asset this year so the liability is reversed and asset recognised)

31 December 20X7

DEBIT Cash £6,000,000
CREDIT Interest income £6,000,000
(Interest on loan at 6% fixed on £100m)

DEBIT Cash £250,000
CREDIT Interest income/expense £250,000
(Net interest received on the swap at 6.25% – 6% = 0.25% of £100m)

DEBIT Loan asset – fair value adjustment £235,294
CREDIT Fair value gain on loan £235,294
(Fair value gain on fixed rate loan due for redemption at par)

DEBIT Fair value loss – interest rate swap £235,294
CREDIT Derivative assets £235,294
(Loss in fair value of interest rate swap now matured)

Extract of statement of profit or loss for years ended 31 December

Amounts in £	20X7	20X6	20X5
Interest income on loan	6,000,000	6,000,000	6,000,000
Net interest income/(expense) on interest rate swap	250,000	(500,000)	-
Fair value gain/(loss) on fixed rate loan	235,294	(1,158,454)	923,160
Fair value gain/(loss) on interest rate swap	(235,294)	1,158,454	(923,160)
Net impact of transaction on profit or loss	6,250,000	5,500,000	6,000,000

Extract of statement of financial position (assets/liabilities only) as at 31 December

Amounts in £	20X7	20X6	20X5
Assets			
Loan notes (before redemption)	100,000,000	99,764,706	100,923,160
Derivative assets	-	235,294	-
Liabilities			
Derivative liabilities	-	-	(923,160)

The effect is as follows.

- The gains and losses on the fair value of loan notes, the hedged item, have been recognised in profit or loss.

- There is a nil net effect in profit or loss, because the hedge has been 100% effective. The net impact on the profit or loss reflects changing market interest rates as a fixed to floating interest rate swap has been used.
- The bank has hedged the fair value risk in the loan notes due to changes in market interest rates. The fair value risk due to changes in credit quality has not been hedged in the above example.

If only particular risks attributable to a hedged item are hedged, the changes in fair value of a hedged financial asset or liability that is not part of the hedging relationship would be accounted for as follows:

- For instruments measured at amortised cost, such changes would not be recognised.
- For instruments measured at fair value through profit or loss, such changes would be recognised in profit or loss in any event.
- For financial assets that are debt instruments at fair value through other comprehensive income, such changes would be recognised in other comprehensive income, as explained above. However exceptions to this would include foreign currency gains and losses on monetary items and impairment losses, which would be recognised in profit or loss in any event.

If the **fair value hedge is 100% effective** (as in the above example), then the change in the fair value of the hedged item will be wholly offset by the change in the fair value of the hedging instrument and there will be **no effect in profit or loss**. Whenever the hedge is not perfect and the change in the fair value of the hedged item is **not fully offset** by change in the fair value of the hedging instrument, the resulting difference will be recognised in profit or loss. This difference is referred to as **hedge ineffectiveness**.



Interactive question 1: Fair value hedge

On 1 January 20X5, High Growth Bank issued £10 million of three-year 5% fixed rate debt, with interest payable annually. High Growth Bank has a BBB credit rating at the date of issuance and accordingly, the fixed interest rate on the debt is 100 basis points higher than the three-year swap rate.

High Growth Bank’s interest rate risk policy requires that all issued debt is effectively at variable rates. The bank entered into an interest rate swap on 1 January 20X5 and designated and formally documented the swap as a fair value hedge of interest rate risk on the fixed rate debt. The swap is a three-year pay LIBOR, receive 4% fixed interest rate swap, with a notional amount of £10 million. High Growth Bank expects the hedge to be highly effective and has documented this assessment.

The fair value of the swap and the carrying amount of the debt, after adjustment for changes in fair value attributable to the hedged risk, were as follows:

	1 January 20X5	31 December 20X5	31 December 20X6
	£m	£m	£m
Issued fixed rate debt	10	12	11
Interest rate swap – asset	Nil	2	1

Requirement

Has High Growth Bank met the hedge accounting criteria of IAS 39?

See **Answer** at the end of this chapter.



Worked example: Fair value hedge of variable rate debt instrument

Does IAS 39 permit an entity to designate a portion of the risk exposure of a variable rate debt instrument as a hedged item in a fair value hedge?

Solution

Yes. A variable rate debt instrument may have an exposure to changes in its fair value due to credit risk. It may also have an exposure to changes in its fair value relating to movements in the market

interest rate in the periods between which the variable interest rate on the debt instrument is reset. For example, if the debt instrument provides for annual interest payments reset to the market rate each year, a portion of the debt instrument has an exposure to changes in fair value during the year.



Interactive question 2: Fair value hedge on investment at fair value through other comprehensive income

Western Bank acquired bonds in SMG InfoTech, on 1 January 20X5 for £300,000. Western Bank classified the investment as fair value through other comprehensive income on initial recognition.

The directors of Western Bank are concerned about the value of the investment in SMG InfoTech's bonds and attempt to hedge against the risk of a fall in its value. The directors wish to use a long put option and apply hedge accounting in accordance with IAS 39.

Requirement

Discuss how both the investment and put option would be subsequently accounted for, assuming that the criteria for hedge accounting were met, in accordance with IAS 39.

See **Answer** at the end of this chapter.

6.2.1 Interest rate futures

An interest rate futures contract has interest-bearing instruments as its underlying asset. Futures contracts are available in relation to short-term interest rates in major currencies like sterling, euros, yen and Swiss francs. These derivatives can be used to gain exposure to, or hedge exposure against, interest rate movements. Three-month sterling future (short sterling) is a 90-day sterling LIBOR interest rate future traded on ICE Futures Europe with the following characteristics:

Unit of trade – £500,000 (this is a notional amount on which interest effect is measured)

Quote – 100 minus interest rate

Tick size – 0.01 (smallest permitted quote movement ie, one basis point)

Tick value – £12.50 ($£500,000 \times 0.01\% \times 3/12$)

The contract is cash settled ie, one party pays to the other the difference in value between the interest for three months at the rate agreed when the contract was originated and actual rate on maturity. If interest rate decreases, a long interest rate futures contract makes a profit, and if interest rate increases, a short interest rate futures contract makes a profit.



Worked example: Fair value hedge using interest rate futures

Moorgate Bank has a fixed rate financial asset of £10 million and is concerned that interest rate will increase from the current levels.

Requirement

Explain how Moorgate Bank can hedge the fair value of the fixed rate financial asset of £10 million against increase in interest rate using interest rate futures.

Solution

If interest rates increase, the fair value of the fixed rate financial asset will decrease. Moorgate Bank requires a futures position that will yield profits when interest rate increases to offset this loss. It should therefore sell $£(10,000,000/500,000) = 20$ futures contracts. If the interest rate increases the gain on the futures position will offset the loss on the fixed rate financial asset.

Moorgate Bank should designate the futures contract as the hedging instrument and the fixed rate financial asset as the hedged item in a fair value hedge. If the IAS 39 conditions for hedge accounting are met the fair value movements on the futures contract and the financial asset will be recognised and offset in profit or loss.



Professional skills focus: Assimilating and using information

To address the hedging requirements of Moorgate Bank above you must understand the business context and recognise the complex ideas within the scenario.

Interest rate options and forward rate agreements are other instruments that may be used to manage interest rate risks on fixed rate assets like loans, bonds or other debt instruments.

6.2.2 Hedging of firm commitments

The hedging of a **firm commitment** should be treated as a **fair value hedge except** that a firm commitment with a **price fixed in foreign currency** may be treated as **either a fair value hedge or a cash flow hedge** of the foreign currency risk.

When an unrecognised firm commitment to acquire an asset or to assume a liability is designated as a hedged item in a fair value hedge, the accounting treatment is as follows:

- The **subsequent cumulative change in the fair value of the firm commitment** attributable to the hedged risk since inception of the hedge is recognised as an asset or liability with a corresponding gain or loss **recognised in profit or loss**.
- The **changes in the fair value of the hedging instrument** are also **recognised in profit or loss**.
- When the firm commitment is **fulfilled**, the initial carrying amount of the asset or liability is **adjusted** to include the cumulative change in the firm commitment that has been recognised in the statement of financial position under the first point above.



Context example: Fair value hedge using futures

On 1 January 20X5 an entity had inventory of 100,000 barrels of oil which had cost it £50 per barrel and which had a selling price (spot price = fair value) of £60 per barrel. The entity was concerned that the fair value might fall over the next six months, so it took out a six-month future to sell at £60 per barrel. On 30 June 20X5, the spot price of the oil had fallen to £57 per barrel. On that date the entity closed out its futures contract and sold its inventory, both transactions being at the spot price.

The sale of 100,000 barrels at £57 generates revenue of £5.7 million; deducting the cost of £5 million, the profit recognised in profit or loss should be £0.7 million.

The entity also makes a profit of £3 (60 - 57) per barrel in the futures market, so on 100,000 barrels a profit of £0.3 million should be recognised in profit or loss.

The combination of the sale and settlement of the futures contract results in proceeds of £(5.7 + 0.3)m = £6m. Subject to any futures market transaction costs, the entity has protected itself against a fall in fair value below £60.

If the spot price of oil was £62 per barrel on 30 June 20X5, the sale of 100,000 barrels of oil would have generated proceeds of £6.2 million and the loss on the futures contract would be £(62 - 60) = £2 per barrel, or £0.2 million for 100,000 barrels. The combination of the sale and settlement of the futures contract results in proceeds of £(6.2 - 0.2)m = £6m. The entity does not realise the benefit of increase in price of oil above £60 because it has hedged at £60 per barrel.

6.3 Portfolio hedge of interest rate risk

An entity can apply **fair value hedge accounting to a portfolio of financial assets and/or financial liabilities for interest rate risk only**. The procedures to be followed are summarised below:

- As part of its risk management process, the entity identifies a portfolio of items whose interest rate risk it wishes to hedge. The portfolio may comprise of only assets, only liabilities or both assets and liabilities.
- The entity analyses the portfolio into repricing time periods based on expected, rather than contractual, repricing dates. As a result, financial assets and financial liabilities with a prepayment option can be included in the portfolio to be hedged.

- The entity designates as the hedged item an amount of assets or liabilities (but not a net amount) from the identified portfolio equal to the amount it wishes to designate as being hedged. This amount also determines the percentage measure that is used for effectiveness testing.
- The entity designates the interest rate risk it is hedging. This risk could be a portion of the interest rate risk in each of the items in the hedged position, such as a benchmark interest rate like LIBOR.
- The entity designates one or more hedging instruments for each repricing time period.
- The entity assesses at inception and in subsequent periods, whether the hedge is expected to be highly effective during the period for which the hedge is designated.
- The entity periodically measures the change in the fair value of the hedged items that is attributable to the hedged risk on the basis of the expected repricing dates. If the hedge is determined to be highly effective using the entity's documented method of assessing effectiveness, the entity recognises the change in fair value of the hedged items as a gain or loss in profit or loss. The change in fair value need not be allocated to individual assets or liabilities.
- The entity measures the change in fair value of the hedging instruments and recognises it as a gain or loss in profit or loss. The fair value of the hedging instrument is recognised as an asset or liability in the statement of financial position.
- Any ineffectiveness is recognised in profit or loss.

The items in the hedged portfolio must be items whose fair value changes in response to hedged interest rate and items that could have qualified for fair value hedge accounting had they been designated individually. An entity is not required to demonstrate that the change in fair value of the individual hedged items is approximately proportional to the overall change in fair value of the portfolio due to interest rate risk. For this hedge, the designated hedged item is expressed as an 'amount of currency' rather than as individual assets or liabilities.

There may be additional ineffectiveness in a fair value hedge of a portfolio hedge of interest rate risk due to actual repricing dates being different from those expected, or expected repricing dates are revised, and hedged item or items in the portfolio become impaired or are derecognised.

6.4 Discontinuation of fair value hedge accounting

Fair value hedge accounting should be discontinued if the hedging instrument expires or is sold, terminated or exercised, if the criteria for hedge accounting are no longer met or if the entity revokes the designation.

The discontinuation should be accounted for prospectively ie, the previous accounting entries are not reversed. The hedged item is not adjusted for any further changes in its fair value and adjustments already made are recognised in profit or loss over the life of the item.

7 Cash flow hedge



Section overview

- A cash flow hedge is a hedge of the variability in an entity's cash flows attributable to a recognised asset or liability, or a high probable forecast transaction.
- The effective portion of the fair value movement on the hedging instrument is recognised in other comprehensive income and reclassified to profit or loss in the same period as the hedged item affects profit or loss. The hedged item is not fair valued.
- Hedge ineffectiveness is recognised in the profit or loss.
- Cash flow hedge accounting is discontinued in certain circumstances and should be accounted for prospectively.

8.1 Overview of cash flow hedge

A cash flow hedge is a **hedge of the variability in an entity's cash flows**. The variability should be attributable to a particular risk associated with:

- the cash flows from a recognised asset or liability; or
- a highly probable forecast transaction

Either of these **could affect profit or loss**.

The use of **interest rate swaps to change floating rate debt into fixed rate debt** is an example of cash flow hedge. The entity is hedging the risk of variability in future interest payments which may arise for instance from changes in market interest rates. The fixed rate protects this cash flow variability (but with the consequence that the fair value of the instrument may now vary in response to market interest movements).

A **forecast transaction** is an uncommitted but **anticipated** future transaction. To **qualify for cash flow hedge accounting**, the forecast transaction should be:

- **specifically identifiable** as a single transaction or a group of individual transactions which share the same risk exposure for which they are designated as being hedged;
- **highly probable**; and
- with a party that is **external** to the entity.

The **hedged forecast transaction must be identified and documented** with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction.

For a **hedge of a forecast transaction**, the documentation of the hedge relationship that is established at inception of the hedge **should identify the date** on which, or **time period** in which, the **forecast transaction is expected to occur**. This is because the hedge must relate to a specific identified risk and it must be possible to measure its effectiveness reliably.

The term '**highly probable**' indicates a much greater likelihood of happening than the term 'more likely than not'. An assessment of the likelihood that a forecast transaction will take place is **not based solely on management's intentions** because intentions are not verifiable. A transaction's probability should be supported by observable facts and circumstances.

In assessing the likelihood that a **transaction will occur**, an **entity should consider** the following circumstances:

- The frequency of similar past transactions
- The financial and operational ability of the entity to carry out the transaction
- Substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity)
- The extent of loss or disruption of operations that could result if the transaction does not occur
- The likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to an offering of ordinary shares)
- The entity's business plan

The **length of time until a forecast transaction is projected** to occur is also a factor in determining probability. Other factors being equal, the **more distant a forecast transaction** is, the **less likely** it is that the transaction would be regarded as highly probable and the stronger the evidence that would be needed to support an assertion that it is highly probable.

For example, a transaction forecast to occur in five years may be less likely to occur than a transaction forecast to occur in one year. However, forecast interest payments for the next 20 years on variable rate debt would typically be highly probable if supported by an existing contractual obligation.

A history of having designated hedges of forecast transactions and then determining that the forecast transactions are no longer expected to occur would call into question both an entity's ability to predict forecast transactions accurately and the propriety of using hedge accounting in the future for similar forecast transactions.

The **hedge of foreign currency assets and liabilities** using forward exchange contracts can be treated as either **a fair value or a cash flow hedge**. This is because movements in exchange rates change both the fair value of such assets and liabilities and ultimate cash flows arising from them. Similarly a

hedge of the foreign currency risk of a firm commitment may be designated as either a fair value or a cash flow hedge.

8.2 Cash flow hedge accounting

If the cash flow hedge meets the conditions for hedge accounting during the period, it should be accounted for as follows:

- The **portion of the gain or loss on the hedging instrument** that is determined to be an **effective hedge** should be **recognised in other comprehensive income and held in a separate component in equity**; and
- the **ineffective portion** of the gain or loss on the hedging instrument should be **recognised in profit or loss**.

On a cumulative basis the **effective portion** can be calculated by adjusting the separate component of equity associated with the hedged item to the **lesser of the following** (in absolute amounts):

- The cumulative gain or loss on the hedging instrument from inception of the hedge
- The cumulative change in the fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge

Any remaining gain or loss on the hedging instrument is the **ineffective portion** and should be recognised in **profit or loss**.

As an exception to the general rule set out above, if an entity designates a non-derivative monetary asset as a foreign currency cash flow hedge of the repayment of the principal of a non-derivative monetary liability, the exchange differences on both the monetary asset and the monetary liability are recognised in profit or loss in the period in which they arise under IAS 21. If there is a hedge relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are recognised in profit or loss.

The following grid will be useful in distinguishing the types of hedge and their treatment.

	Firm commitment	Forecast transaction (highly probable)
Foreign currency	Either fair value hedge or cash flow hedge	Cash flow hedge
Other	Fair value hedge	Cash flow hedge



Worked example: Cash flow hedge 1

Eastern Bank enters into a pay variable, receive fixed interest rate swap in order to protect its future cash inflows relating to a recognised variable rate financial asset held at amortised cost. At inception the value of the interest rate swap was £Nil, but by the year end a gain of £12,000 was made when measured at fair value. The corresponding loss in respect of the hedged item amounted to £14,700 in fair value terms.

Requirement

Explain how the transaction should be accounted for, including treatment of hedge ineffectiveness, if any.

Solution

The hedge is fully effective as the gain on the hedging instrument is less than the loss on the hedged item and the gain of £12,000 is therefore all recognised in other comprehensive income. The double entry is:

DEBIT Derivative assets	£12,000	
CREDIT Other comprehensive income		£12,000

The hedged item is not fair valued in a cash flow hedge and normal classification rules apply ie, it is carried at amortised cost.

8.2.1 Reclassification of gains/losses to profit or loss

If a hedge of a forecast transaction subsequently results in the recognition of **a financial asset or liability**, the associated gains or losses that were recognised previously in other comprehensive income, should be **reclassified** to profit or loss in the same period or periods during which the asset acquired, or liability assumed, affects profit or loss, such as in the periods when the interest income or expense is recognised.

If a hedge of a forecast transaction results in the recognition of **a non-financial asset or liability**, then the entity should adopt either of the following approaches as its accounting policy to be applied consistently.

- It should **reclassify the associated gains and losses** that were previously recognised in **other comprehensive income into profit or loss** in the same period or periods during which the asset acquired or the liability assumed affects profit or loss (such as in the periods when a depreciation expense or cost of sales is recognised). However if an entity expects that all or a portion of a loss recognised in other comprehensive will not be recovered in one or more future periods, it should **reclassify to profit or loss the amount that is not expected to be recovered**.
- It should **remove the associated gains and losses** that were recognised in other comprehensive income and **include them in the initial cost** or other carrying amount of that asset or liability (this adjustment to the carrying amount is often referred to as basis adjustment).

Both these policies result in all the gains/losses originally recognised in other comprehensive income being reclassified to profit or loss.

If **a forecast transaction for a non-financial asset or liability becomes a firm commitment**, for which fair value hedge accounting is applied, one of the above two approaches should also be followed based on the entity's choice of accounting policy.



Worked example: Cash flow hedge 2

On 1 October 20X5, HDF Bank, whose functional currency is British pounds (GBP), entered into a contract to provide advisory services to a corporate in United States for next six months. The fees agreed were \$600,000 payable on 31 March 20X6. In fixing this US dollar (USD) price it worked on the basis of the spot exchange rate of $\$1.50 = \text{£}1$, so that revenue would be £400,000. This revenue would be recognised as per the applicable IFRS in full on 31 March 20X6 when the work is completed (no revenue or receivables are recognised before 31 March 20X6).

HDF Bank is concerned that USD will depreciate against GBP and enters into a six-month futures contract on 1 October 20X5 to sell \$600,000 for £400,000.

On 31 December 20X5 (which is the company's reporting date) the spot exchange rate was $\$1.60 = \text{£}1$. The futures contract was therefore worth £25,000 ($\text{£}400,000 - (\$600,000/1.60)$) and HDF bank recognised that amount as a financial asset and a gain in other comprehensive income (ignore the impact of discounting).

On 31 March 20X6 the spot exchange rate was $\$1.45 = \text{£}1$ and the futures contract was a liability of £13,793 ($\text{£}400,000 - (\$600,000/1.45)$) when it was settled and payment of \$600,000 fees was received for services provided. The bank sold USD received for GBP at spot rate on the same date.

Requirement

Explain the accounting entries for the above transaction if:

- (1) the futures contract is not designated as a hedging instrument; or
- (2) the futures contract is designated as a hedging instrument in an effective hedge.

Solution

The futures contract is a derivative and would normally be fair value through profit or loss. If this is however designated as a hedging instrument in a cash flow hedge and the other IAS 39 requirements for hedging accounting are met, then the effective portion of the fair value movements on the futures contract would be taken to other comprehensive income. This would affect the profit or loss in the same period as the hedged item.

The futures contract has been assumed to have zero value on initiation.

(1) Futures contract is not designated as a hedging instrument

31 December 20X5

DEBIT Derivative assets	£25,000	
CREDIT Gain on futures contract – Profit or loss		£25,000
(Gain on futures contract in 20X5)		

31 March 20X6

DEBIT Loss on futures contract – Profit or loss	£38,793	
CREDIT Derivative assets		£25,000
CREDIT Derivative liabilities		£13,793
(Loss on futures contract in 20X6)		
DEBIT Derivative liabilities	£13,793	
CREDIT Cash		£13,793
(Settlement of futures contract)		
DEBIT Cash	£413,793	
CREDIT Revenue		£413,793
(Fee income of \$600,000 converted at spot rate of \$1.45 = £1)		

The net cash received is $£(413,793 - 13,793) = £400,000$ if we take the combination of fee income and futures contract. However, the profit or loss for 20X5 would show a gain of £25,000, and the profit or loss for 20X6 would show a gain of $£(413,793 - 38,793) = £375,000$ if hedge accounting is not applied.

(2) Futures contract is designated as a hedging instrument

If hedge accounting is applied, the gain or loss on the hedging instrument would be recognised in other comprehensive income (instead of profit or loss) until the hedged item affects profit or loss. This ensures that both the hedged item and hedging instrument affect the profit or loss in the same period.

The accumulated loss of £13,793 would be recognised in other comprehensive income (OCI) and transferred to profit or loss on 31 March 20X6 when the hedged item is recognised and affects profit or loss. Thus, the net gain of $£(413,793 - 13,793) = £400,000$ is recognised in profit or loss in 20X6.

31 December 20X5

DEBIT Derivative assets	£25,000	
CREDIT Gain on futures contract – OCI		£25,000
(Gain on futures contract designated as hedging instrument in an effective hedge in 20X5)		

31 March 20X6

DEBIT Loss on futures contract – OCI	£38,793	
CREDIT Derivative assets		£25,000
CREDIT Derivative liabilities		£13,793
(Loss on futures contract designated as hedging instrument in an effective hedge in 20X6)		

20X6)		
DEBIT Derivative liabilities	£13,793	
CREDIT Cash		£13,793
(Settlement of futures contract)		
DEBIT Cash	£413,793	
CREDIT Revenue		£413,793
DEBIT Loss on futures contract – Profit or loss	£13,793	
CREDIT Loss on futures contract – OCI		£13,793
(Fee income of \$600,000 converted at spot rate of \$1.45 = £1; Accumulated losses of £13,793 recognised in OCI on futures contract designated as hedging instrument reclassified to profit or loss as the fees, the hedged item, are recognised in profit or loss)		

Note that the bank had locked in a rate of \$1.50 = £1 as it expected the USD to depreciate. Since the USD had appreciated during the period the bank could not get the benefit of USD currency appreciation as it incurred a loss on the futures contract. It would have been better off not entering into the futures contract, however the purpose of cash flow hedging is to reduce the risk ie, variability in cash flows in foreign currency. This objective has been met.

If the bank wanted to be hedged only for the downside risk (USD depreciating against the GBP) but retain the upside, then it would enter into an options contract.



Interactive question 3: Cash flow hedge

On 1 January 20X5, Indus Bank originates a loan of £100 million at market rate + 2% for three years. The interest is payable in arrears at the end of the year ie, 31 December. The bank believes that interest rates are likely to decline, and simultaneously enters into an interest rate swap contract with notional principal of £100 million, three-year term. Under the swap contract, the bank pays at the end of each year interest at market rate at the beginning of the year, and receives a fixed rate of 3%.

Indus Bank designates the swap as a cash flow hedge of the variability in interest receipts on the loan attributable to changes in market rates. All the criteria for cash flow hedge accounting are met and the hedge is highly effective.

Year	Market rate at beginning of the year	Net receipt/(payment) on swap	Interest on loan	Net receipt
		£m	£m	£m
20X5	3%	-	5	5
20X6	2%	1	4	5
20X7	4%	(1)	6	5

The combination of the loan and interest rate swap results in net cash flow at 5%.

The fair value of the interest rate swap is as follows:

31 December 20X5: £1,942,000 asset

31 December 20X6: £(962,000) liability

Requirement

Explain with journal entries and extracts of financial statements how the above transaction is recognised by Indus Bank for each of the three years?

See **Answer** at the end of this chapter.



Worked example: Foreign currency liability

Indigo Bank has a US dollar liability payable in six months' time and it wishes to hedge the amount payable on settlement against sterling and US dollar (GBP/USD) fluctuations. To that end, it takes out a forward contract to buy US dollars for GBP in six months' time. The conditions for hedge accounting were met.

Requirement

Should the hedge be treated as a fair value hedge of the US dollar liability or as a cash flow hedge of the amount to be settled in the future?

How should gains and losses on the liability and the forward contract be accounted for?

Solution

IAS 39 allows both of these two methods.

Fair value hedge

The gain or loss on the fair value remeasurement of the hedging instrument and the gain or loss on the fair value remeasurement of the hedged item (foreign currency liability) for the hedged risk should be recognised immediately in profit or loss.

Cash flow hedge

The portion of the gain or loss on remeasurement of the forward contract that is an effective hedge should be recognised in other comprehensive income. The amount should be reclassified in profit or loss in the same period or periods during which the hedged item (the liability) affects profit or loss ie, when the liability is remeasured for changes in foreign exchange rates. Therefore, if the hedge is effective, the gain or loss on the derivative is released to profit or loss in the same periods during which the liability is measured, not when the payment occurs.

The purpose of hedge accounting is to ensure that the impact of the hedged item and hedging instrument on the profit or loss occurs in the same period. The profit or loss as a result reflects the results of risk management activities of the bank.

8.3 Discontinuation of cash flow hedge accounting

Cash flow hedge accounting should be discontinued if the hedging instrument expires or is sold, terminated or exercised, if the criteria for hedge accounting are no longer met, a forecast transaction is no longer expected to occur or if the entity revokes the designation.

The discontinuation should be accounted for prospectively ie, the previous accounting entries are not reversed. The cumulative gain or loss on the hedging instrument should be reclassified to profit or loss as the hedged item is recognised in profit or loss.

9 Hedge of a net investment



Section overview

- A hedge of a net investment in a foreign operation is a hedge of the foreign currency exposure to changes in the reporting entity's share in the net assets of that operation.
- Net investment hedge is permitted only in consolidated financial statements.
- The effective portion of gain or loss on the hedging instrument is recognised in other comprehensive income. This amount is reclassified to profit or loss on disposal of the foreign operation.
- Hedge ineffectiveness is recognised in profit or loss.

10.1 Overview of net investment hedge

In a hedge of a **net investment in a foreign operation** the hedged item is **the amount of the reporting entity's interest in the net assets of that operation**. Monetary items that are receivable from or payable to a foreign operation for which settlement is neither planned nor likely to occur in the foreseeable future form part of the net investment.

IAS 21, *The Effects of Changes in Foreign Exchange Rates* requires that the reporting entity's share in the net assets of a foreign operation is translated into the group's presentation currency with the retranslation gain or loss recognised directly in equity.

Net investment hedge is permitted only in **consolidated financial statements** as it is only there that the net assets of the foreign operation are recognised.

10.2 Net investment hedge accounting

Hedges of a net investment in a foreign operation should be accounted in a **similar way to cash flow hedges**, that is:

- the **portion** of gain or loss on the hedging instrument that is determined to be an **effective hedge** should be **recognised** in other comprehensive income; and
- the **ineffective portion** should be **recognised in profit or loss**.

The gains or losses on the hedging instrument that has been recognised in other comprehensive income should be **reclassified to profit or loss** on disposal of the foreign operation. If only part of an interest in a foreign operation is disposed of, only the relevant proportion of this gain or loss should be reclassified to profit or loss. This makes it necessary to **track the gains or losses on hedging instruments** recognised in equity for each individual foreign operation separately, in order to be able to identify the amount to be recognised in profit or loss on the sale of a specific foreign operation.

10.2.1 Hedging with a non-derivative financial instrument

A non-derivative financial asset or liability can only be designated as a hedging instrument for hedges of foreign currency risk. So a foreign currency borrowing can be designated as a hedge of a net investment in a foreign operation, with the result that any translation gain or loss on the borrowing should be recognised in other comprehensive income to offset the translation loss or gain on the investment (normally gains or losses on such financial liabilities are recognised in profit or loss).

Context example: Non-derivative to hedge a net investment

Ideal Bank, whose functional currency is sterling, has a subsidiary in Germany. The subsidiary was purchased on 31 December 20X4 for €50 million and the acquisition was financed with a loan of €50 million. There was no goodwill on acquisition. Ideal Bank has designated the foreign currency loan of €50 million as a hedge of its first €50 million net investment in the foreign subsidiary.

Ideal Bank has a 31 December year end. The foreign currency rates at 31 December 20X4 and 31 December 20X5 were £1 = €1.25 and £1 = €1.35 respectively. In the year ended 31 December 20X5 the exchange difference on the opening net investment should be calculated as:

	€	£
At 31 December 20X4	50,000,000	40,000,000
At 31 December 20X5	50,000,000	37,037,037
Translation loss recognised in other comprehensive income		<u>2,962,963</u>

There is a corresponding gain on the foreign currency loan of $\pounds\{(50,000,000/1.25) - (50,000,000/1.35)\} = \pounds2,962,963$. As the hedge is perfectly effective, both the gain and loss will be recognised in other comprehensive income. There is no ineffective portion of the loss on the hedging instrument to be recognised in profit or loss.

10.2.2 Hedging with derivatives

A net investment in a foreign operation can be hedged with a derivative instrument such as a currency forward contract or cross-currency swap contract. If these derivatives are not designated as hedging instruments in net investment hedge, the fair value changes on them are recognised in profit or loss while retranslation gain or loss is recognised in other comprehensive income. This creates volatility in the profit or loss.

It is important to **identify and document clearly what risk is hedged** using forward contract or cross-currency swap. If the forward rate is hedged, the full change in fair value of the forward is taken to equity if it is fully effective. If the spot rate is hedged, the changes in fair value due to spot element of the forward is taken to equity and the remainder changes in fair value being due to the forward points is recognised in profit or loss. The **amount accumulated in equity is recycled** out of equity when the net investment is sold.

10.2.3 IFRIC 16, Hedges of a Net Investment in a Foreign Operation

IFRIC 16 clarifies that a parent entity may designate as a hedged risk only the foreign exchange differences arising from a difference between its own functional currency and that of its foreign operation. The presentation currency does not create an exposure to which an entity may apply hedge accounting.

11 Summary of hedge accounting

The following table summarises the accounting treatment under IAS 39 of the three types of hedges.

	Fair value hedge	Cash flow hedge/Net investment hedge
Gain or loss on hedging instrument	Profit or loss	Other comprehensive income
Fair value adjustment to hedged item	Profit or loss	None
Hedge ineffectiveness	Profit or loss	Profit or loss
Gains or loss reclassified to profit or loss	Not applicable	Yes

12 Hedged items



Section overview

- A hedged item exposes the entity to risk of changes in fair value or future cash flows.
- A hedged item could be an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation.
- A hedged item could be a single item or a group of items with similar risk characteristics. It could be a financial or non-financial item.
- An overall net position cannot be designated as a hedged item for hedge accounting purposes in IAS 39.
- A number of items like own equity instruments, derivatives and overall business risks do not qualify as hedged items.



Definitions

Hedged item: An asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that:

- exposes the entity to risk of changes in fair value or future cash flows; and
- is designated as being hedged.

Firm commitment: A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

Forecast transaction: An uncommitted but anticipated future transaction.

Firm commitments and forecast transactions are normally not recognised in financial statements.

13.1 Financial risks

Hedged items as defined above are **exposed to a variety of risks** that affect the value of their fair value or cash flows. For hedge accounting, these risks **need to be identified** and **hedging instruments which modify the identified risks** selected and designated. The risks for which the above items can be hedged are normally classified as:

- Market risk
 - Price risk
 - Interest rate risk
 - Currency risk
- Credit risk
- Liquidity risk

IAS 39 allows for a portion of the risks or cash flows of an asset or liability to be hedged. The hedged item may, for example, be a fixed rate liability, exposed to foreign currency risk, where only the interest rate and currency risk are hedged but the credit risk is not hedged.

13.2 Nature of hedged items

- The **hedged item** can be:
 - a single asset, liability, unrecognised firm commitment, highly probable forecast transaction or net investment in a foreign operation;
 - a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics; or
 - a portion of a portfolio of financial assets or financial liabilities which share exposure to interest rate risk. In such a case the portion of the portfolio that is designated as a hedged item is a hedged item with regard to interest rate risk only.
- Assets and liabilities designated as hedged items can be **either financial or non-financial items**.
 - **Financial items** can be designated as hedged items for the risks associated with only a **portion** of their cash flows or fair values. So a fixed rate liability which is exposed to foreign currency risk can be hedged in respect of currency risk, leaving the credit risk not hedged.
 - **Non-financial items** such as inventories shall only be designated as hedged items **for foreign currency risks or for all risks**. The reason is that it is not possible to separate out the appropriate portions of the cash flow or fair value changes attributable to specific risks other than foreign currency risk.
- **Unrecognised** assets and liabilities **cannot be designated as hedged items**. So, unrecognised intangibles cannot be hedged items.
- The hedge should be with a **party external** to the entity. For example, a hedge could be between two entities within the same group ie, an entity level hedge in which case it cannot be a hedge in consolidated financial statements. If such a hedge applies to only one of the two entities in the group, then the hedge accounting adjustments may need to be reversed on consolidation. As an exception, an **intra-group monetary item qualifies as a hedged item** in the consolidated financial statements if it results in an exposure to foreign exchange rate gains and losses that are not eliminated on consolidation.



Intra-group hedge

The functional currency of Blue Bank and its subsidiary Green Bank are GBP and USD respectively. Green Bank invoices \$1 million to Blue Bank just before the year end for services rendered. The amount remains unsettled at the year end.

While the inter-company balances are eliminated on consolidation, the exchange differences that arise in Blue Bank from retranslation of the monetary liability are not eliminated on consolidation. Hence, the inter-company monetary item can be designated as a hedged item in a foreign currency hedge.

13.3 Designation of a group of assets as hedged items

IAS 39 permits the designation of a group of assets as a hedged item provided that the following **two conditions** are met.

- The **individual assets or liabilities in the group share the risk exposure** that is designated as being hedged.
- The change in the fair value attributable to the hedged risk **for each individual item in the group** is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group items.



Worked example: Group of assets

Green Bank constructs a portfolio of shares based on FTSE 250 stock index and uses a put option on the index to protect itself from fair value losses.

Requirement

Can the portfolio of shares be designated as a hedged item?

Solution

The portfolio of shares **cannot** be designated as a hedged item as the change in fair value attributable to the hedged risk for each individual item in the group (individual share prices) is not expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group; even if the index rises, the price of an individual share may fall.

13.4 Hedging an overall net position

Although an entity's hedging strategy and risk management practices may assess cash flow risk on a net basis IAS 39 **does not permit an overall net position to be designated as a hedged item** for hedge accounting purposes. The reason for this is that in a hedging relationship the gains or losses in the hedging instrument will need to be allocated to the individual items in the net position. This is difficult since in a net position there may be assets or liabilities which may have payoffs different to that of the hedging instruments. However, the same purpose can be achieved by designating a part of the gross items, equal to the net position, as the hedged item.



Worked example: Hedging net position

Max Bank, a UK bank, has a highly probable forecast income of £1 million, and highly probable forecast expense of £800,000.

Requirement

Explain how Max Bank can hedge the net exposure of £200,000 in IAS 39.

Solution

Max Bank cannot hedge the net exposure of £200,000 as per IAS 39. The same effect can be achieved by designating part of the highly probable forecast income equal to the net exposure. Max Bank should designate the first £200,000 of income as hedged item.

13.5 Items that do not qualify as hedged items

Because the hedged item must expose the entity to risk of changes in the fair value or future cash flows that could affect the profit or loss, a number of items cannot qualify as hedged items. These items are:

- the entity's own equity instruments
- equity method investments and investments in consolidated subsidiaries in respect of fair value hedges
- future earnings
- derivative instruments
- general business risk

These non-qualifying items are analysed below.

13.5.1 Own equity instruments

Hedge accounting does not apply for hedges of items included in equity or transactions that directly affect equity. A highly probable forecast transaction in the entity's own equity instruments or forecast dividend payments to shareholders both relate to transactions which will be recognised in the statement of changes in equity, so they cannot be designated as a hedged item in a cash flow hedge. However, a declared dividend that has not yet been paid and is recognised as a financial liability may qualify as a hedged item, for example for foreign currency risk if it is denominated in a foreign currency.

13.5.2 Equity method investments and investment in subsidiaries in respect of fair value hedges

An **equity method investment** (eg, associate entity) or **investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge** in consolidated financial statements. This is because it is the investor's share of the profit or loss of the associate entity, or the subsidiary's profit or loss that is recognised rather than the changes in investment's fair value.

A **hedge of a net investment in a foreign operation** is a hedge of the **foreign currency exposure**, not a fair value hedge of the change in the value of the investment.

13.5.3 Future earnings

Future earnings cannot be hedged items because they are the net result of different transactions with different risk profiles. Highly probable forecast transactions can be hedged items.

13.5.4 Derivative instruments

IAS 39 **does not permit** designating a **derivative instrument** (whether a stand-alone or a separately recognised embedded derivative) as a **hedged item**.

13.5.5 Business risk

IAS 39 does not permit an entity to apply hedge accounting to overall business risk as it cannot be specifically identified and measured. The risk that a transaction will not occur is an **overall business risk** that **is not eligible** as a hedged item. Hedge accounting is permitted only for risks associated with recognised assets and liabilities, firm commitments, highly probable forecast transactions and net investments in foreign operations.

14 Hedging instruments



Section overview

- A hedging instrument is a designated derivative whose fair values or cash flows are expected to offset changes in the fair value or cash flow of a designated hedged item.
- A hedging instrument could be non-derivative only for a hedge of the risk of changes in foreign currency exchange rates.
- Financial assets and liabilities whose fair value cannot be reliably measured cannot be designated as hedging instruments.
- A hedging instrument is generally designated in a hedging relationship in its entirety. There are exceptions like options, forward contracts or where a proportion of hedging instrument is designated in the hedge.



Definition

Hedging instrument: A designated derivative or, for a hedge of the risk of changes in foreign currency exchange rates only, a designated non-derivative financial asset or non-derivative financial liability, whose **fair values or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item**.

Financial assets and liabilities whose fair value cannot be reliably measured cannot be designated as hedging instruments.

The types of hedging instruments that can be designated in hedge accounting are as follows.

- Derivatives, such as forward contracts, futures contracts, options and swaps
- Non-derivative financial instruments, but only for the hedging of currency risk.

Any derivative financial instrument, with the exception of written options to which special rules apply, **can be designated as a hedging instrument**. Derivative instruments have the important property that their fair value is highly correlated with that of the underlying.

Options provide a more flexible way of hedging risks compared to other derivative instruments such as forwards, futures and swaps, because they give to the holder the choice as to whether or not to exercise the option.

Purchased options, whether call options or put options, have the potential to hedge **price, currency and interest rate risks** and can always qualify as hedging instruments. Examples of purchased options include options on equities, options on currencies and options on interest rates. An interest rate floor is achieved through a put option on an interest rate, and an interest rate cap is achieved through a call option on an interest rate.

15.1 Designation as hedging instrument in whole or in part

In a hedging relationship, the hedging instrument is normally designated in its entirety. The only exceptions are that the following are permitted (but not required):

- Separating the intrinsic value of an option and its time value and designating only the change in the intrinsic value as the hedging instrument
- Separating the interest element and the spot price of a forward

These exceptions recognise that the intrinsic value of the option and the interest element on the forward can be measured separately. The element of the derivative that is not designated as a hedging instrument will be fair value through profit or loss.



Interactive question 4: Designation as a hedging instrument in part

Southern Bank has issued a variable rate debt for £50 million. It has also entered into a pay fixed receive variable interest rate swap that it wishes to designate as hedging the issued variable rate debt. The notional on the swap is £100 million. The remaining term on the variable rate debt and the interest rate swap is three years.

Requirements

- 4.1 Can Southern Bank designate the interest rate swap as a hedging instrument?
- 4.2 Would your answer be different if the term of the variable rate debt is three years and of the interest rate swap is six years?

See **Answer** at the end of this chapter.

16 *Conditions for hedge accounting*



Section overview

- This section discusses the conditions for hedge accounting.
 - At inception of the hedge there must be a formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.
 - The hedge should be expected to be highly effective and must be assessed for effectiveness on an ongoing basis.
 - The effectiveness of the hedge can be assessed on a period-by-period basis or cumulative basis.
-

17.1 Designation and documentation

Documentation must include the following:

- Identification of the hedging instrument and the hedged item or transaction
- Date on, or period in which highly probable forecast transaction is expected to occur
- Nature of the risk being hedged
- Details of how the hedge effectiveness will be calculated
- A statement of the entity's risk management objective and strategy for undertaking the hedge

Note that retrospective designation with the benefit of hindsight is not permitted. Hedge accounting may only be applied prospectively, from the later of the date of designation and the date that the formal documentation is prepared. This date may be later than the date on which an entity acquires the hedging instrument itself.



Hedge documentation

A UK-based airline company with GBP as its functional currency may forecast highly probable purchases of jet fuel in US dollars for the next nine months and enter into forward contracts with a bank to buy jet fuel. The airline company may not be able to forecast individual purchase transactions in respect of the purchase of jet fuel but can still treat a number of purchases, as for example, first 50,000 metric tonnes, as highly probable forecast transactions and designate the forward contracts as hedging instruments under a cash flow hedge.

If the forward contracts are settled net, the airline company receives the excess of market price over the agreed fixed price and pays the bank the amount of any deficit of such market price under the fixed price.

17.2 Hedge effectiveness



Definition

Hedge effectiveness: The degree to which the changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

Hedge effectiveness should be tested on both a **prospective and retrospective basis** because hedge accounting should only be applied when:

- at the time of designation the **hedge is expected to be highly effective**; and
- the hedge turns out to have been **highly effective throughout the financial reporting periods** for which it was designated.

As a minimum an entity should assess hedge effectiveness at inception, and when preparing interim or annual financial statements.

Hedge effectiveness should be determined in accordance with the methodology in the hedge documentation. The highly effective hurdle is achieved if the **actual results** of a hedge are within the range **from 80% to 125%**. **Hedge ineffectiveness** is always recognised in **profit or loss**.

IAS 39 does not specify a method to be used in assessing the effectiveness of a hedge. Several **mathematical techniques** can be used **to measure hedge effectiveness**.

One of the ways of calculating this is to express the absolute amount of the change in value of the hedging instrument as a percentage of the absolute amount of the change in value of the hedged item, or vice versa. In addition to this **ratio analysis method**, statistical measurement techniques such as **regression analysis** may be used. Regression analysis is useful to determine the validity and extent of relationship between an independent and dependent variable. If regression analysis is used, the entity's documented policies for assessing effectiveness must specify how the results of the regression will be assessed.

The **method** chosen should, however, be based on an **entity's risk management strategy**, documented upfront and applied consistently over the duration of the hedging relationship. Hedge effectiveness is always based on dirty prices.

17.2.1 Requirement to assess effectiveness

IAS 39 requires an entity to assess hedge effectiveness on an ongoing basis. An entity cannot assume hedge effectiveness just because the principal terms of the hedging instrument and of the hedged item are the same. This is because hedge ineffectiveness may arise because of other attributes such as the liquidity of the instruments or their credit risk.

It may, however, designate only certain risks in an overall exposure as being hedged and thereby improve the effectiveness of the hedging relationship.



Worked example: Designation of part of overall exposure

Indigo Bank issues three-year fixed rate debt. Based on market rates of interest and Indigo Bank's credit rating, it is able to issue debt at 5%. The 5% rate comprises three-year interest rate risk of 3.5% and a credit spread of 1.5%.

Requirement

Can Indigo Bank designate the hedged risk as changes in the fair value of the debt associated with changes in interest rate risk only?

Solution

Yes, Indigo Bank can exclude from the designation its own credit spread. This will increase the effectiveness of the hedge relationship because the equivalent credit risk inherent in the debt is not reflected in the terms of the hedging derivative, say an interest rate swap.

17.2.2 Periodic or cumulative assessment

IAS 39 allows hedge effectiveness to be assessed **separately for each period** or **cumulatively over the life of the hedging relationship**. The hedge documentation should incorporate how hedge effectiveness would be assessed if it may be assessed only on a cumulative basis.

The effect of using a cumulative basis is that even if a hedge is not expected to be highly effective in a particular period, hedge accounting is still permitted if effectiveness is expected to remain sufficiently high over the life of the hedging relationship. However, ineffectiveness in any period is required to be recognised in profit or loss as it occurs.



Context example: Periodic or cumulative assessment

In the period by period approach the changes in the fair value of the hedging instrument are compared to the changes in the fair value of the hedged item attributable to the hedged risk during each period.

The cumulative approach compares the cumulative changes in the fair value of the two instruments from the inception of the hedge until the test date.

Assessment period	Period by period basis Changes in the fair value			Cumulative basis Changes in the fair value		
	Hedging instrument	Hedged item	Ratio	Hedging instrument	Hedged item	Ratio
Quarter 1	100	(100)	100%	100	(100)	100%
Quarter 2	110	(114)	96%	210	(214)	98%
Quarter 3	48	(26)	184%	258	(240)	108%
Quarter 4	(28)	8	350%	230	(232)	99%

In this example the hedge is not effective in Quarters 3 and 4 if tested on a period-by-period basis but it is effective throughout the four quarters if tested on a cumulative basis. It would therefore be vital in this case that the hedging documentation specified effectiveness testing on a cumulative basis.

17.2.3 After-tax basis

IAS 39 permits, but does not require, assessment of hedge effectiveness on an after-tax basis. If the hedge is undertaken on an after-tax basis, it should be so designated at inception as part of the formal documentation of the hedging relationship and strategy.

17.2.4 Credit risk

- In assessing the effectiveness of a hedge, both on inception of the hedge relationship and subsequently, an entity must consider the likelihood of default by the counterparty to the hedging instrument.
- For a cash flow hedge, if it becomes probable that counterparty **will default**, an entity would be **unable to conclude** that the **hedging relationship is expected to be highly effective** in achieving offsetting cash flows. As a result, hedge accounting should be **discontinued**.
 - For a fair value hedge, if there is a **change in the counterparty's creditworthiness**, the fair value of the hedging instrument will change, which **affects the assessment** of whether the **hedge relationship is effective** and whether it qualifies for continued hedge accounting.

17.3 Impact on financial statements

Hedge accounting may involve a deviation from the normal accounting rules for recognition and measurement of financial instruments designated as hedged item or hedging instrument. This is to ensure that the **fair value movements** on the **hedged item** and **hedging instrument** affect the **profit or loss** in the **same period**. It is a requirement for **IAS 39 hedges to be properly documented and effectiveness tested** on an ongoing basis in order to apply hedge accounting.

In practice, it is important that there are procedures in place to ensure hedged items and hedging instruments are not used in another hedging relationship at the same time by another part of the group. The auditors need to ensure that hedge accounting was applied after the documentation was complete with objective of risk management, identification of hedged item and hedging instruments (with trade IDs), type of hedge and method of hedge effectiveness testing clearly stated. The hedge accounting entries and disclosures also need to be audited.

A hedge may be designated at entity, bank or group level, and so depending on the entity in which the hedge accounting adjustments have been recognised, further adjustments may be necessary. For example, if the hedge is designated at entity level but not group level, any adjustments made to the entity's financial statements may need to be reversed on consolidation.

IFRS 7, *Financial Instruments: Disclosures* requires disclosures in relation to description of types of hedges, nature of risks being hedged and hedge ineffectiveness which is discussed in Chapter 11.

18 IFRS 9 changes in hedge accounting



Section overview

- IFRS 9 introduces a more principles-based approach to hedge accounting aligned to risk management activities of an entity.
- The hedge accounting terminology and types of hedges are the same as IAS 39.
- IFRS 9 allows more exposures to be hedged and non-derivatives to be designated as hedging instruments.
- The hedge effectiveness testing has been made more objective with the 80% - 125% rules-based criteria removed.
- Voluntary discontinuation of hedge accounting is not permitted when the risk management objective has not changed for the hedging relationship.

19.1 Background

The IAS 39 hedge accounting rules have been criticised as being complex and not reflecting the way an entity normally manage their risks. The IASB addressed these issues in IFRS 9 which adopts a more principles-based approach aligned to the normal risk management activities of an entity. The IASB will allow an accounting policy choice to apply either the IFRS 9 hedging model or the IAS 39 model, with an additional option to use IAS 39 for macro hedging (currently a separate project) if using IFRS 9 for general hedge accounting.

The accounting for macro hedging is not part of IFRS 9 and IASB has decided to develop an accounting approach for dynamic risk management as a separate project.

19.2 IFRS 9 hedge accounting

A number of areas have been re-addressed in IFRS 9; however, the **following does not change** from IAS 39:

- Hedge accounting is a choice and is not required to be applied.
- The terminology used in IAS 39 and IFRS 9 is generally the same.
- The three types of hedges – fair value hedge, cash flow hedge and net investment hedge are the same.

- Hedge ineffectiveness is recognised in profit or loss except for other comprehensive income option for equity investments.
- Hedge accounting with written options is prohibited.

The key areas which have been re-addressed in IFRS 9 are discussed below:

19.2.1 Hedged items

IFRS 9 permits the following additional exposures to be designated as hedged items, which is not allowed under IAS 39.

Risk components of non-financial items

In IAS 39, a non-financial item can only be designated as the hedged item for its foreign currency risk or for all of its risks, but there is not such restriction for financial items.

IFRS 9 allows **separately identifiable and reliably measurable risk components of non-financial items** to be designated as hedged items.

Components

IFRS 9 allows a component that is a proportion of an entire item or a **layer component** to be designated as a hedged item in a hedging relationship. A layer component may be specified from a defined, but open, population or a defined nominal amount. For example, an entity could designate 20% of the fixed rate bond as hedged item, or the top layer of £20 principal from a total amount of £100 (defined nominal amount) of fixed-rate bond. It is necessary to track the fair value movements of the nominal amount from which the layer is defined.

Groups of items and net positions

In IAS 39, groups of items are eligible as hedged items only if the designated items within the group share the same designated risk exposure. In addition, the change in fair value attributable to the hedged risk for each individual item within the group should be approximately proportional to the overall change in the fair value attributable to the hedged risk of the group. These restrictions are not consistent with the way many entities manage risk.

IFRS 9 allows hedge accounting to be applied to **groups of items and net positions** if the group consists of individually eligible hedged items and those items are managed together on a group basis for risk management purposes.

For a **cash flow hedge of a group of items**, if the variability in cash flows is not expected to be approximately proportional to the group's overall variability in cash flows, the **net position is eligible** as a hedged item only **if it is a hedge of foreign currency risk**. In addition, the designation must specify the reporting period in which forecast transactions are expected to affect profit or loss, including the nature and volume of these transactions.

Aggregated exposures

IAS 39 does not allow hedge accounting for aggregated exposures ie, a combination of non-derivative exposure and a derivative being the hedged item.

IFRS 9 allows **aggregated exposures** that include a derivative to be **eligible hedged item**.



Context example: Aggregated exposure as hedged item

Moorgate Bank has a fixed rate foreign currency loan which exposes it to both foreign exchange rate risk and fair value risk due to changes in interest rates. The bank enters into a cross-currency interest rate swap to eliminate the foreign exchange risk and fair value risk due to changes in interest rates but is now exposed to variable functional currency interest payments.

Moorgate Bank may hedge the aggregated exposure (foreign currency loan + cross-currency interest rate swap) by using, for example, a pay fixed and receive floating interest rate swap in its own functional currency.

Equity investments at fair value through other comprehensive income

IFRS 9 allows an entity to classify equity investments not held for trading, at fair value through other comprehensive income through an irrevocable option on initial recognition of the instrument. The gains and losses are recognised in other comprehensive income and are never reclassified to profit or loss.

IFRS 9 allows these equity investments at fair value through other comprehensive income to be designated as hedged items. In this case, both the effective and ineffective portion of the fair value changes in the hedging instruments are recognised in other comprehensive income.

Fair value designation for credit exposures

Many banks use credit derivatives to manage credit risk exposures arising from their lending activities. The hedges of credit risk exposure allow banks to transfer the risk of credit loss to a third party. This may also reduce regulatory capital requirements.

IAS 39 allows the fair value option to be applied if it eliminates or significantly reduces an accounting mismatch. However, this election is only available at initial recognition, is irrevocable and requires the financial instrument, like a loan, to be designated in its entirety. As a result, banks **do not often achieve hedge accounting** on credit risk of the exposures with the result that the fair value changes on credit derivatives, like credit default swaps create **volatility in the profit or loss**.

IFRS 9 allows **credit exposure or part of the credit exposure** to be measured at **fair value through profit or loss** if an entity uses a **credit derivative** measured at **fair value through profit or loss** to manage the credit risk of all, or part of, the credit exposure. In addition, an entity may make the designation at initial recognition or subsequently, or while the financial instrument is unrecognised.



Interactive question 5: Credit derivative and credit exposures

Excel Bank extends a fixed rate loan commitment of £1 million to a customer. The bank's risk management strategy is to hedge the credit risk exposure of any individual loan commitment to the extent that it exceeds £500,000. As a result, Excel Bank enters into a credit default swap of £500,000 in relation to this loan commitment to the customer.

Requirement

Explain the accounting for the credit default swap and the loan commitment under IAS 39 and IFRS 9.

See **Answer** at the end of this chapter.

19.2.2 Hedging instruments

The key changes in IFRS 9 in respect of eligibility and accounting for hedging instruments are as follows:

Eligibility of hedging instruments

IAS 39 requires hedging instruments to be derivatives except for hedge of foreign currency risk.

IFRS 9 allows both derivatives at fair value through profit or loss and non-derivative financial assets or financial liabilities measured at fair value through profit or loss to be hedging instruments (with the exception of financial liability designated at fair value through profit or loss with changes in fair value attributable to changes in credit risk recognised in other comprehensive income).

An entity may exclude the following from hedging relationships:

- Time value of purchased options
- Forward element of forward contracts and foreign currency basis spreads

Time value of purchased options

The change in **fair value of the time value of the option** is recognised in **profit or loss** in **IAS 39**. This can create volatility in profit or loss.

In **IFRS 9**, an entity may **designate only the change in intrinsic value** of a purchased option as the hedging instrument in a fair value or cash flow hedge. The change in **fair value of the time value of the option** is recognised in **other comprehensive income** to the extent it relates to the hedged item. This change in IFRS 9 makes options more attractive as hedging instruments.

The method used to reclassify the amounts from equity to profit or loss is determined by whether the hedged item is transaction related or time-period related.

The time value of a purchased option relates to a **transaction related hedged item** if the nature of the hedged item is a transaction for which the time value has the character of costs of the transaction. For example, future purchase of a commodity or non-financial asset.

The **change in fair value of the time value of option (transaction related hedged item)** is accumulated in other comprehensive income over the term of the hedge, to the extent it relates to the hedged item. It is then treated as follows:

- If the hedged item results in the recognition of a **non-financial asset or liability or firm commitment** for a non-financial asset or liability, the amount accumulated in equity is removed and included in the **initial cost or carrying amount** of the asset or liability.
- For **other hedging relationships**, the amount accumulated in equity is **reclassified to profit or loss** as a reclassification adjustment in the period(s) in which the hedged expected cash flows affect profit or loss.



Context example: Time value of purchased option related to a transaction related hedged item

On 30 September 20X8, Domingo Ltd enters into a contract to purchase wheat in three months' time for £120,000. On the same date, Domingo purchases a wheat option for delivery in January 20X9.

The fair value movements of the firm commitment and the intrinsic value of the option are recognised in profit or loss. The time value of the option accumulates in other comprehensive income, to the extent that it relates to the hedged item. On recognition of the purchase of wheat, the time value of the option is removed from equity and included in the initial cost of the wheat.

The time value of a purchased option relates to a **time-period related hedged item** if the nature of the hedged item is such that the time value has the character of the cost for obtaining protection against a risk over a particular time period but the hedged item does not result in a transaction that involves the notion of a transaction cost. For example, price risk of a commodity or interest rate risk of a bond.

The **change in fair value of the time value of option (time-period related hedged item)** is accumulated in other comprehensive income over the term of the hedge, to the extent it relates to the hedged item. The time value of the option at the date of designation is amortised on a straight-line or other systematic and rational basis, and the amortisation amount is reclassified to profit or loss as a reclassification adjustment.



Context example: Time value of purchased option related to a time-period related hedged item

On 1 December 20X8, Zooey Bank purchases floating rate bonds. On the same date, Zooey Bank purchases an interest rate floor option, under which Zooey Bank will receive payments at the end of each period in which the interest rate is below the agreed strike price (interest rate).

This is a time-period related hedged item as the option provides protection against interest rate risk for a set period of time.

The fair value movements of the floating rate bonds and the intrinsic value of the option are recognised in profit or loss. The time value of the purchased floor option will accumulate in other comprehensive income and will be amortised over the length of time that the option protects Zooey Bank against interest rate risk.

Forward points and foreign currency basis spreads

In **IAS 39**, if only the spot component is designated as part of the hedging relationship, the **forward points** are recognised in **profit or loss** on a fair value basis.

IFRS 9 allows these forward points to be treated in a similar manner as that allowed for the time value component on options. The change in fair value of the forward points is recognised in **other comprehensive income** and accumulated in equity. This is then **amortised to profit or loss** on a systematic and rational basis.

IFRS 9 also allows **foreign currency basis spread** in a foreign currency derivative to be excluded from designation as the hedging instrument and treated in a similar manner as allowed for forward points.

19.2.3 Hedge effectiveness

Under **IFRS 9**, the 80%–125% 'bright line' test of whether a hedging relationship qualifies for hedge accounting was replaced by an objective-based assessment ie:

- There is an **economic relationship** between the hedged item and the hedging instrument ie, the hedging instrument and the hedged item have values that generally move in the opposite direction because of the same risk, which is the hedged risk.
- The effect of **credit risk does not dominate** the value changes that result from that economic relationship ie, the gain or loss from credit risk does not frustrate the effect of changes in the underlying on the value of the hedging instrument or the hedged item, even if those changes were significant.
- The **hedge ratio** of the hedging relationship (quantity of hedging instrument vs quantity of hedged item) is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. For example, if an entity hedges 90% of the exposure on an item, it should designate the hedging relationship using a hedge ratio that is the same as that resulting from 90% of the exposure and the quantity of the hedging instrument that the entity actually uses to hedge those 90%.

This allows genuine hedging relationships to be accounted for as such whereas the **IAS 39** rules sometimes prevented management from accounting for an actual hedging transaction as a hedge.

In **IAS 39**, **changes to a hedging relationship** generally require **discontinuation of hedge accounting** which could result in hedge ineffectiveness that is inconsistent with the risk management view of the hedge.

In **IFRS 9**, if a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio but the risk management objective for that designated hedging relationship remains the same, the entity can **adjust the hedge ratio** so that it **meets the qualifying criteria** again in which case discontinuation is not required. This is referred to as **rebalancing**.

19.2.4 Discontinuation of hedge accounting

In **IAS 39**, hedge accounting is discontinued when hedging instrument expires or is sold, terminated or exercised, the hedge no longer meets the criteria for hedge accounting, the entity revokes the designation or for cash flow hedges, the forecast transaction is no longer probable.

In **IFRS 9**, **voluntary discontinuation** of hedge accounting **is not permitted** when the risk management objective has not changed for the hedging relationship.

19.3 Impact on financial statements

IFRS 9 introduces a principles-based approach that aligns hedge accounting with risk management. It requires **use of judgement**, in particular with regard to whether hedging relationships will meet the **hedge effectiveness criteria** and when **rebalancing will be required**. There are additional exposures that may be hedged and more instruments, including non-derivatives that may be designated as hedging instruments. The entity will need to have **appropriate processes** in place to identify new hedging opportunities, and ensure that the extensive **new disclosure requirements** are met. The **auditors** will need to **test management judgements** with regards to hedge effectiveness criteria, and also obtain comfort over the fair value measurement of components of non-financial hedged items, purchased options, forward contracts and cross-currency swaps.

20 *Impact of LIBOR reform*



Section overview

- Interest rate benchmarks, such as LIBOR, are being replaced by the end of 2021 at the latest.
- Interest rate benchmark reform will impact the continuation of hedge accounting because a different rate will be used to price the hedged item and hedging instrument.
- The IASB has announced some amendments to IFRS 9, IFRS 7 and IAS 39.
- Phase 2 of the amendments are expected to be published in late 2020 or in 2021.

The interest rate benchmark LIBOR, the London Interbank Offered Rate, is widely used to price mortgages, loans, bonds and derivatives. LIBOR is expected to cease at the end of 2021, with its replacement being SONIA - the Sterling Overnight Index Average. LIBOR transition is a large project that impacts all banks.

The change in benchmark interest rates could result in hedge accounting needing to be discontinued. This could result in reclassifications of amounts in cash flow hedge reserves to profit or loss and discontinuation of the fair value hedge accounting of fixed rate debt.

The amendments modify some specific hedge accounting requirements to provide relief from potential effects of the uncertainty caused by the IBOR reform. In addition, the amendments require entities to provide additional information to investors about their hedging relationships which are directly affected by these uncertainties. This is Phase 1 of the IASB's response. The Board has started work on Phase 2, which considers the potential consequences on financial reporting of replacing an existing benchmark with an alternative and an exposure draft was published in April 2020.

The Phase 1 amendments come into effect for accounting periods beginning on or after 1 January 2020 but companies may choose to apply them earlier.

For cash flow hedges, the amendments require that an entity assumes that hedged LIBOR-based cash flows will continue beyond the period when they could potentially be replaced by cash flows based on an alternative rate. This applies irrespective of whether LIBOR-based variability is contractual (eg, existing LIBOR-linked debt) or non-contractual (eg, a forecast debt issuance).

Similarly, for fair value hedges, the amendments require that LIBOR risk continues to be treated as identifiable in the hedged item even if this ceases to be the case.

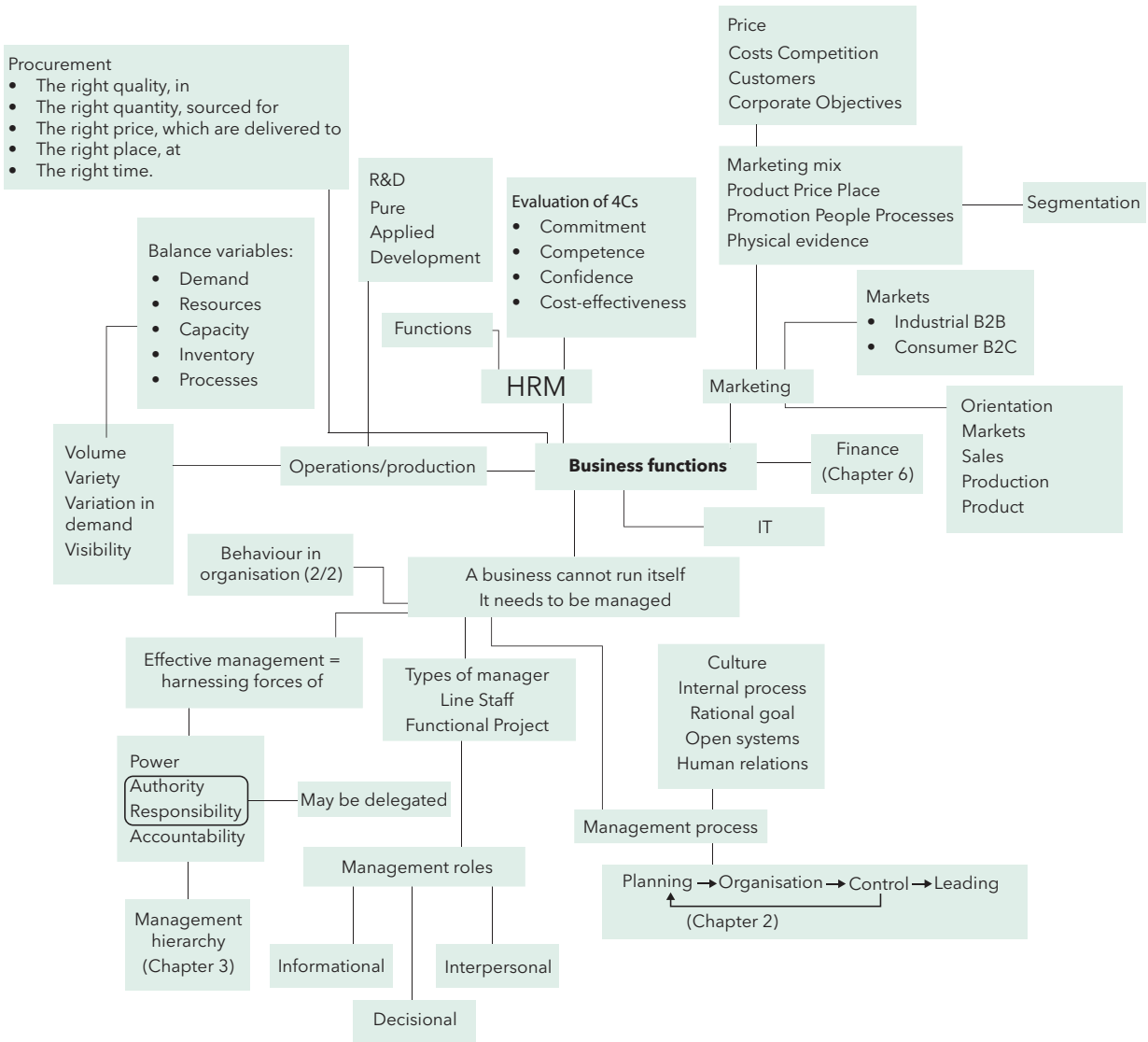
When performing prospective assessments, an entity shall assume that the interest rate benchmark on which the hedged item, hedged risk and/or hedging instrument are based is not altered as a result of the interest rate benchmark reform.

An entity is also not required to apply the IAS 39 retrospective assessment for hedging relationships directly affected by the reform. The entity must comply with all other IAS 39 hedge accounting requirements, including the prospective assessment, but would not discontinue hedge accounting if the hedge falls outside the 80% - 125% range during the period of uncertainty arising from the reform.

The amendments are to be applied retrospectively to hedge relationships that existed during the period in which an entity first applies the amendments and to gains or losses in the cash flow hedge reserve at the beginning of that period. Given the amendments ensure continuity of hedge accounting, early adoption is advisable. Where chosen, entities will need to clearly state that they have early adopted and in doing so, include the associated disclosures in their annual financial statements.

Phase 2 will deal with the financial reporting issues that may arise when an existing interest rate benchmark is actually replaced. For example, whether changing the interest rate benchmark in a contract will result in discontinuation of the hedge. Given the potential disruption to hedge accounting when these changes take place, it may be advisable for banks to delay changes to contractual terms until the amendments are announced.

Summary



Further question practice

1 Knowledge diagnostic

Before you move on to question practice, complete the following knowledge diagnostic and check you are able to confirm you possess the following essential learning from this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1	Do you understand the hedge accounting policy choice? (Topic 1)
2	Do you understand the overview of IAS 39 hedge accounting? (Topic 2)
3	Do you understand what a fair value hedge is? (Topic 3)
4	Do you understand what a cash flow hedge is? (Topic 4)
5	Do you understand a hedge of a net investment in a foreign operation? (Topic 5)
6	Do you understand the summary of hedge accounting? (Topic 6)
7	Do you understand which exposures may be designated as hedged items? (Topic 7)
8	Do you understand hedging instruments? (Topic 8)
9	Do you understand the conditions for hedge accounting? (Topic 9)
10	Do you understand the IFRS 9 changes in hedge accounting? (Topic 10)
11	Do you understand the benchmark changes and the effect on hedge accounting (Topic 11)?

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Question name	Learning benefit from attempting this question
2	Lime Street Bank	This question covers the hedging rules including journal entries.
3	Idex Bank	This question covers the hedging rules including journal entries.
4	Northern Bank	This question covers IFRS hedging rules.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Question name	Learning benefit from attempting this question
4 (part 3 only)	Broadgate Bank	This question asks for the financial reporting treatment of an interest rate swap under IAS 39.
27 (parts 1 and 2 only)	Wynton	This question asks for the financial reporting treatment of an interest rate swap under IFRS 9.
32 (part 1 only)	BritBank	This question covers a number of issues, including the financial reporting treatment of hedging in requirement 1(e).

Technical reference

1 IAS 39 hedge accounting

- Definition – **IAS 39.85**
- Conditions – **IAS 39.88**
- Types of hedging relationships – **IAS 39.86-87**
- Examples – **IAS 39 AG 102-104**

2 Hedged items

- Qualifying item – **IAS 39.78,80, AG 99A**
- Items that cannot be designated – **IAS 39 AG 98-99**
- Intra-group transactions – **IAS 39.80**
- Portion of an instrument as a hedged item – **IAS 39.81**
- Groups of assets as hedged instruments – **IAS 39.83-84**
- Interest rate exposure of a portfolio – **IAS 39.81A**
- Non-financial assets – **IAS 39.82, AG 100**

3 Hedging instruments

- Qualifying instruments – **IAS 39.72-73**
- Written and purchased options – **IAS 39 AG 94**
- Non qualifying instruments – **IAS 39 AG 95-97**
- Designations of hedging instruments – **IAS 39.74-77**

4 Fair value hedges

- Definition – **IAS 39.86**
- Recognition of gains or losses – **IAS 39.89**
- Discontinuing fair value hedge accounting – **IAS 39.91**

5 Cash flow hedges

- Definition – **IAS 39.86**
- Recognition of gains or losses – **IAS 39.95**
- Hedge of a forecast transaction – **IAS 39.97**
- Discontinuing cash flow hedge accounting – **IAS 39.101**

6 Hedges of a net investment – IAS 39.102

7 Hedge effectiveness

- Criteria – **IAS 39 AG 105**
- Timing of assessment – **IAS 39 AG 106**
- Methods of assessing effectiveness – **IAS 39 AG 107**

8 IFRS 9 hedge accounting

- Objective and scope – **IFRS 9.6.1.1-3**
- Conditions – **IFRS 9.6.4.1, B6.4.1-19**
- Types of hedging relationships – **IFRS 9.6.5.2**
- Rebalancing – **IFRS 9.6.5.5, B6.5.7-21**
- Discontinuing hedge accounting – **IFRS 9.6.5.6, B6.5.22-28**

9 Hedged items

- Qualifying item – **IFRS 9.6.3.1-5, B6.3.1-6**
- Designation of hedged items – **IFRS 9.6.3.7, B6.3.7-15**
- Group of items – **IFRS 9.6.6.1, B6.6.1-12**
- Designation of component – **IFRS 9.6.6.2-3, B6.3.16-25**

10 Hedging instruments

- Qualifying item – **IFRS 9.6.2.1-3, B6.2.1-4**
- Designation of hedging instruments – **IFRS 9.6.2.4-6, B6.2.5-6**
- Accounting for time value of options – **IFRS 9.6.5.15, B6.5.29-33**
- Accounting for forward element of forward contracts and foreign currency basis spreads – **IFRS 9.6.5.16, B6.5.34-39**

11 Fair value hedges

- Definition – **IFRS 9.6.5.2**
- Recognition of gains or losses – **IFRS 9.6.5.8**

12 Cash flow hedges

- Definition – **IFRS 9.6.5.2**
- Recognition of gains or losses – **IFRS 9.6.5.11-12**

13 Hedges of a net investment – IFRS 9.6.5.13-14

Self-test questions

Answer the following questions.

1 Notting Hill Bank

Notting Hill Bank, a UK bank with GBP functional currency originates a US dollar loan for six months. At the same time, the bank takes out a six-month forward exchange contract to sell US dollars for GBP to hedge its foreign currency exposure. The IFRS 9 conditions for hedge accounting were met.

Under IAS 21, *The Effects of Changes in Foreign Exchange Rates*, the loan is recorded at the spot rate at the date of origination, and restated during the six-month period for changes in GBP/USD exchange rates with the difference being taken to profit or loss (IAS 21.23 and IAS 21.28).

Requirement

If the foreign exchange forward contract is designated as a hedging instrument, would the bank designate it as a fair value hedge of the foreign currency exposure of the loan or as a cash flow hedge of the loan?

How should gains and losses on the loan and the forward contract be accounted for?

2 Lime Street Bank

Lime Street Bank is preparing its financial statements in GBP as at 31 December 20X5. The 'Loans to customers' balance includes an amount of \$3 million due from a customer in United States. The loan was originally recognised when the exchange rate was £1 = \$1.50 on 1 October 20X5.

At 31 December 20X5, the exchange rate was £1 = \$1.40. No adjustment has been made to the loan balance since it was initially recognised.

The bank did not want to be exposed to GBP/USD exchange rate fluctuations on this loan and on the date of origination had entered into a forward contract to sell \$3 million on the same date as maturity of the loan. The bank satisfies the IAS 39 hedge accounting criteria and designates this as a cash flow hedge.

In the period between inception of the forward contract and 31 December 20X5, the loss in fair value of the forward contract was £150,000. The bank elected to designate the spot element of the forward contract in the hedge. The difference between the change in fair value of the loan and the change in fair value of the forward contract since inception is the forward element of the forward contract.

Requirement

Show how this transaction should be accounted for in the financial statements of Lime Street Bank for the year ended 31 December 20X5.

3 Idex Bank

Idex Bank, whose functional currency is sterling, has a subsidiary in the United States. The subsidiary was purchased on 31 December 20X4 for \$100 million (no goodwill on acquisition) and the acquisition was financed with a loan of \$100 million. Idex Bank has designated \$80 million of the foreign currency loan as a hedging instrument of the first \$80 million of net investment in the foreign subsidiary. The designation is spot retranslation risk only.

Idex Bank has a 31 December year end. The foreign currency rates at 31 December 20X4 and 31 December 20X5 were £1 = \$1.50 and £1 = \$1.60 respectively.

Requirement

Explain the impact of the above transaction on the 20X5 financial statements of Idex Bank.

4 Northern Bank

On 1 January 20X5, Northern Bank issued at £70 million (par value) of fixed rate 5% bonds to the market at par. Interest on the bonds is paid quarterly on the last day of each quarter (ie, 1.25% per

quarter on 31 March, 30 June, 30 September and 31 December). The bonds will be redeemed on a future specified date at par.

To comply with the bank's risk management policies, it entered into a receive-fixed, pay-variable interest rate swap agreement at market rates on £70 million to hedge the fair value of its debt for interest rate risk. The terms of the swap are to pay the agreed variable rate established and fixed at the beginning of each quarter and receive 4% per annum fixed rate in return. The swap has the same maturity date as that of the bonds.

The variable interest rate applicable to the swap for the three months to 31 March 20X5 determined on 1 January 20X5 was 3% per annum.

As a result of a rise in market interest rates, the fair value of the bonds issued fell to £69,400,000 by 31 March 20X5. The net fair value of the swap at the 31 March 20X5 was £604,000 (loss).

No transaction costs were incurred on issue of the bonds or on entering into the swap agreement. All necessary documentation for fair value hedge was set up on 1 January 20X5.

Requirement

Explain, with reference to IFRS 9, how this should be accounted for in the financial statements as at 31 March 20X5. Your answer should include a list of conditions to be met in order to apply hedge accounting, relevant calculations and journal entries (in so far as the information provided permits).

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

The IAS 39 hedge accounting criteria has been met.

- **Hedged item:** The fair value of the issued fixed rate debt will vary with changes in market interest rates, and this could impact profit or loss if the debt is extinguished early. Therefore, the debt qualifies as a hedged item.

The carrying amount of the debt represents the amortised cost and an element of fair value movement which is due to changes in interest rates since inception of the hedging relationship.

- **Principal terms:** The principal terms (principal/notional amounts, timing of cash flows, opposite direction of the fixed cash flows, and maturity) of hedged item and hedging instrument match. This implies that the changes in fair value attributable to the interest rate risk in the fixed rate debt is likely to offset the changes in fair value of the interest rate swap, both at inception and afterwards. An assessment of hedge effectiveness is however required initially and then on an on-going basis.
- **Hedge effectiveness:** The bank expects the hedge to be highly effective and has documented the hedging relationship and hedge effectiveness assessment. The changes in credit risk will affect the fair value of the hedged item, but the only hedged risk is the interest rate risk. Therefore, changes in credit spreads will not affect hedge effectiveness.

Answer to Interactive question 2

Under the normal rules of IAS 39, the gain or loss on a FVTOCI financial asset is recognised in **other comprehensive income** and the gain or loss on put option is recognised in **profit or loss**.

Since the long put option meets the criteria to be treated as a hedging instrument in a **fair value hedge**, it means that:

- the gain or loss on the financial asset (the 'hedged item') would be taken to **profit or loss**; and
- this would be offset by the corresponding loss or gain on the long put option.

This treatment is a fair reflection of the economic substance of the hedging arrangement, where the intention is that the changes in intrinsic value of the long put option will cancel out the changes in fair value of the hedged item. However, the change in time value of the long put option (for which there is no offsetting fair value movement in the hedged item) is also recognised in profit or loss. These changes in time value of the option will create volatility in the profit or loss.

Answer to Interactive question 3

The journal entries required are as follows.

1 January 20X5

DEBIT Loan asset	£100,000,000	
CREDIT Cash		£100,000,000
(Loan origination)		

31 December 20X5

DEBIT Cash	£5,000,000	
CREDIT Interest income		£5,000,000
(Interest on loan at market rate + 2% = 5% on £100m)		
DEBIT Derivative assets	£1,942,000	
CREDIT Other comprehensive income		£1,942,000

(Fair value gain on interest rate swap/cash flow hedging reserve)

No net interest is settled on the swap as the fixed and market rates are the same.

31 December 20X6

DEBIT Cash	£4,000,000	
CREDIT Interest income		£4,000,000
(Interest on loan at market rate + 2% = 4% on £100m)		
DEBIT Cash	£1,000,000	
CREDIT Interest income		£1,000,000
(Net interest received on the swap at 3% - 2% = 1% of £100m)		
DEBIT Other comprehensive income	£2,904,000	
CREDIT Derivative assets		£1,942,000
CREDIT Derivative liabilities		£962,000
(Fair value loss on interest rate swap which was an asset in previous period, now a liability)		

31 December 20X7

DEBIT Cash	£6,000,000	
CREDIT Interest income		£6,000,000
(Interest on loan at market rate + 2% = 6% on £100m)		
DEBIT Interest income/expense	£1,000,000	
CREDIT Cash		£1,000,000
(Net interest paid on the swap at 4% - 3% = 1% of £100m)		
DEBIT Derivative liabilities	£962,000	
CREDIT Other comprehensive income		£962,000
(Fair value gain on interest rate swap matured on 31 December 20X7)		

Extract of statement of profit or loss for years ended 31 December

Amounts in £	20X7	20X6	20X5
Interest income on loan	6,000,000	4,000,000	5,000,000
Net interest income/(expense) on interest rate swap	(1,000,000)	1,000,000	-
Net impact of transaction on profit or loss	5,000,000	5,000,000	5,000,000

Extract of statement of other comprehensive income for years ended 31 December

Amounts in £	20X7	20X6	20X5
Fair value gain/(loss) on hedging instruments in cash flow hedge	962,000	(2,904,000)	1,942,000

Extract of statement of financial position as at 31 December - Debit/(Credit)

Amounts in £	20X7	20X6	20X5
Assets			
Loan notes (before redemption)	100,000,000	100,000,000	100,000,000
Derivative assets	-	-	1,942,000
Liabilities			
Derivative liabilities	-	(962,000)	
Equity			
Cash flow hedging reserve	-	962,000	(1,942,000)

The effect is as follows.

- The gains and losses on the interest rate swap used as a hedging instrument in a cash flow hedge are recognised in other comprehensive income and accumulated in equity as cash flow hedging reserve. The hedged item is not fair valued.
- The profit or loss reflects net interest income of £5,000,000 every year as a combination of loan and interest rate swap.
- The bank has hedged the cash flow risk in the loan due to changes in market interest rates. The fair value risk due to changes in credit quality has not been hedged in the above example.

Answer to Interactive question 4

- 4.1 A proportion of the entire hedging instrument may be designated as the hedging instrument. Southern Bank can designate £50 million notional of the pay fixed receive variable swap as hedging instrument of the variable rate debt. The remaining £50 million notional will be measured at fair value through profit or loss unless it is designated as a hedging instrument in another hedging relationship.
- 4.2 A hedging relationship cannot be designated for only a portion of the time period that the hedging instrument is outstanding. Southern Bank cannot designate three of the five years of the swap as being hedging instrument. However, say if the term of the variable rate debt is five years and the interest rate swap is three years, the variable rate debt can be hedged for the first three years.

Answer to Interactive question 5**IAS 39**

The credit default swap (CDS) is recognised as a derivative at fair value through profit or loss. The loan commitment cannot be fair value through profit or loss as IAS 39 does not allow fair value option for a proportion of an exposure. As a result, there will be volatility in the profit or loss since there is no offset for the fair value changes in the CDS.

IFRS 9

The credit default swap (CDS) is recognised as a derivative at fair value through profit or loss. IFRS 9 allows fair value option for a proportion of the loan commitment. If this option is elected, then £500,000 of the loan commitment is accounted for at fair value through profit or loss and as a result provides an offset to the fair value through profit or loss on the CDS.

Answers to Self-test questions

1 Notting Hill Bank

Notting Hill Bank can designate a fair value hedge or a cash flow hedge under IFRS 9.

Fair value hedge

The gain or loss from remeasurement of the foreign exchange forward contract at fair value is recognised immediately in profit or loss and the gain or loss on remeasurement of the loan is also recognised in profit or loss in the same period. These would offset each other in the profit or loss.

Cash flow hedge

If the bank designates the foreign exchange forward contract as a cash flow hedge of the foreign currency risk associated with the loan, the portion of the gain or loss that is determined to be an effective hedge should be recognised in other comprehensive income, and the ineffective portion in profit or loss. The amount held in equity should be reclassified to profit or loss in the same period or periods during which changes in the measurement of the loan affect profit or loss.

2 Lime Street Bank

Foreign currency loan

	£
Original recognition on 1 October 20X5 (3,000,000/1.5)	2,000,000
Loan balance at 31 December 20X5 (3,000,000/1.4)	<u>2,142,857</u>
Foreign exchange gain on loan recognised in profit or loss	<u>142,857</u>

31 December 20X5

DEBIT Loans to customers	£142,857	
CREDIT Profit or loss		£142,857
(Foreign exchange gain on US dollar loan to customer)		
DEBIT Other comprehensive income	£142,857	
DEBIT Profit or loss (forward points)	£7,143	
CREDIT Derivative liabilities		£150,000
(Change in fair value of forward contract; effective portion in other comprehensive income)		
DEBIT Profit or loss	£142,857	
CREDIT Other comprehensive income		£142,857
(Reclassification to profit or loss as hedged item affects profit or loss in current period)		

In a cash flow hedge, the effective portion of the fair value movement on the hedging instrument is recognised in other comprehensive income and reclassified to profit or loss in the period in which the hedged item affects profit or loss. Any ineffectiveness and also changes in fair value of the forward contract due to forward points not included in the hedging relationship is recognised in profit or loss.

3 Idex Bank

Idex Bank has designated a net investment hedge and so the fair value movements on the \$80 million of the loan is recognised in other comprehensive income to offset the gain or loss on translation of net assets of the subsidiary. The fair value movements on the remaining \$20 million of the loan which is not designated as part of the hedge is recognised in profit or loss.

DEBIT Loans liability	£4,166,667	
CREDIT Other comprehensive income		£3,333,333
CREDIT Profit or loss		£833,334
(Foreign exchange gain on \$100 million of foreign currency loan due to change in exchange rate from £1 = \$1.50 to £1 = \$1.60; 80% recognised in other comprehensive income, 20% in profit or loss)		
DEBIT Other comprehensive income	£4,166,667	
CREDIT Net assets (investment in subsidiary)		£4,166,667
(Loss on retranslation of net assets in US subsidiary due to depreciation of the US dollar)		

4 Northern Bank

Northern Bank has entered into a receive-fixed, pay-variable interest rate swap to hedge the fair value of its own fixed rate debt. This is a fair value hedge and in order to apply hedge accounting, the following criteria must be met as per IFRS 9:

- (The hedging relationship consists only of eligible hedging instruments and eligible hedged items.
- At the inception of the hedge, there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.
- The hedge relationship meets the hedge effectiveness requirements:
 - There is an economic relationship between the hedged item and hedging instrument;
 - the effect of credit risk does not dominate the value changes that result from that economic relationship; and
 - the hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item.

If, at any time, any of these criteria are not met, hedge accounting may need to be rebalanced or discontinued.

The bond is initially recognised at its fair value of £70 million at inception. Interest for the first three months is accrued and paid. As there are no transaction costs and no redemption premium, the effective interest rate to be applied to the bonds is the same as the nominal rate. Therefore the profit or loss charge will equal the interest actually paid:

	£
Cash	70,000,000
Effective interest for the quarter ($70,000,000 \times 5\% (3/12)$)	875,000
Coupon interest paid	<u>(875,000)</u>
Balance of liability at 31 March 20X5	<u>70,000,000</u>

The double entries are:

	£	£
DEBIT Finance costs	875,000	

	£	£
CREDIT Bonds issued		875,000
DEBIT Bonds issued	875,000	
CREDIT Cash		875,000

The interest rate swap is initially recognised at its fair value. Given that it was entered into at 'market rates', its fair value is zero at 1 January 20X5 so there will be no specific accounting entry on that date. Disclosures will however be required under IFRS 7, *Financial Instruments: Disclosures*.

The net interest of (4% – 3% = 1%) on the swap is recognised as follows:

Net interest £(70m × 1% × 3/12) = £175,000 (income)

	£	£
DEBIT Cash	175,000	
CREDIT Net interest income on swap		175,000

At the year end, the fair value hedge accounting rules are applied.

The gain in the bonds issued during the period is £70,000,000 – £69,400,000 = £600,000.

The change in the fair value of the swap is recognised as a derivative liability in the statement of financial position and is reported as a loss in profit or loss as follows:

	£	£
DEBIT Fair value loss	604,000	
CREDIT Derivatives liability		604,000

Under fair value hedge accounting, the change in fair value of the hedged item is also recognised in profit or loss, any difference between the two being ineffectiveness of the hedge:

	£	£
DEBIT Bonds issued	600,000	
CREDIT Fair value gain		600,000

The overall effect on the **statement of financial position** is as follows:

	£
Bonds issued 1 January 20X5	70,000,000
Change in fair value of bonds	(600,000)
Bonds issued at 31 March 20X5	69,400,000
Derivatives liability	604,000
Amount in statement of financial position	<u>70,004,000</u>

The initial fair value of the bonds issued of £70 million has been effectively hedged. Without hedge accounting, profit or loss would be distorted by showing the loss of £604,000 on the swap, as the corresponding gain on the bonds issued would not be recognised (as they would still be held at their amortised cost of £70 million).

Impact on statement of comprehensive income for the period ended 31 March 20X5 (extracts)

	£
Net interest income on swap	175,000
Interest expense on bonds issued	(875,000)

	£
Other income – Fair value gain on hedged item	600,000
Other expense – Fair value loss on hedging instrument	<u>(604,000)</u>
Net expense	<u>(704,000)</u>

Statement of financial position as at 31 March 20X5 (extracts)

	£
Current assets	
Cash	X + 175,000 – 875,000
Non-current liabilities	
Bonds issued	69,400,000
Derivatives liability	604,000
Equity	
Retained earnings	X – 704,000

Appendix

Tax Tables FA2020

Syllabus area: Administration

SUBMISSION DATES

Submission dates for 2020/21 personal self-assessment tax returns

	Later of: 31 January 2022
Return filed online	3 months from the date of issue of return
	Later of: 31 October 2021
Paper returns	3 months from the date of issue of return

Submission dates for corporation tax returns

Must be filed by 12 months from the end of the period of account.

Submission dates for PAYE information: Real Time Information

Information	Filing date
Full Payment Submission (FPS)	On or before the day the employee is paid
P60 (to employees)	31 May following the tax year end
P11D	6 July following the tax year end

PAYMENT DATES

Payment dates for income tax

Payment	Filing date
First interim payment ⁽¹⁾	31 January in the tax year
Second interim payment ⁽¹⁾	31 July following the tax year end
Balancing payment	31 January following the tax year end

(1) Interim payments are not required if the tax paid by assessment for the previous year was less than:

£1,000; or

20% of the total tax liability (income tax and Class 4)

Payment dates for capital gains tax

Capital gains tax is payable by 31 January following the tax year end.

Payment dates for corporation tax

Corporation tax	Nine months and one day after the end of an accounting period
Corporation tax by instalments – large companies	The 14 th day of months 7, 10, 13 and 16 counted from the start of a 12-month accounting period
Corporation tax by instalments – very large companies	The 14 th day of months 3, 6, 9 and 12 counted from the start of a 12-month accounting period

Payment dates for VAT

	Due date
Electronic payment	7 calendar days after the last day of the month following the end of the return period
Direct debit payment	Collected automatically 3 working days after electronic payment due date

MAIN PENALTY PROVISIONS

PENALTIES FOR INCORRECT RETURNS

The penalties are a percentage of the potential lost revenue

Reason for penalty	Maximum penalty	Minimum penalty with unprompted disclosure	Minimum penalty with prompted disclosure
Careless action	30%	Nil	15%
Deliberate but not concealed action	70%	20%	35%
Deliberate and concealed action	100%	30%	50%

PENALTIES FOR FAILURE TO NOTIFY

Failures to notify chargeability to tax, or liability to register for tax that leads to a loss of tax will result in a penalty. The penalties are a percentage of the potential lost revenue.

Reason for penalty	Maximum penalty	Minimum penalty with unprompted disclosure		Minimum penalty with prompted disclosure	
Deliberate and concealed action	100%	30%		50%	
Deliberate but not concealed action	70%	20%		35%	
		>12m	<12m	>12m	<12m
Any other case	30%	10%	Nil	20%	10%

COMPANIES: PENALTIES

Offence	Maximum Penalty
Failure to notify chargeability within 12 months of end of accounting period	See above: penalties for failure to notify

Corporation tax: penalties for late filing of a corporation tax return

Offence	Penalty ⁽¹⁾
Late return, up to 3 months late	£100 fixed penalty, or £500 for persistent failure
Return more than 3 months late	£200 fixed penalty, or £1,000 for persistent failure
Return filed more than 18 months but less than 24 months after end of return period	Tax geared penalty of 10% of tax unpaid 18 months after end of return period
Return filed more than 24 months after end of return period	Tax geared penalty of 20% of tax unpaid 18 months after end of return period

(1) The tax geared penalty is charged in addition to the fixed penalty but only one of each type of penalty is charged.

INDIVIDUALS: PENALTIES

Offence	Maximum Penalty
Failure to notify chargeability by 5 October following tax year end	See above: penalties for failure to notify
Late payment of income tax or capital gains tax: ⁽¹⁾	
Unpaid 30 days after payment due date	5% of tax unpaid
Unpaid 6 months after payment due date	Further 5% of tax unpaid
Unpaid 12 months after payment due date	Further 5% of tax unpaid

(1) Late payment penalties do not apply to payments on account.

Income tax and CGT: penalties for late filing of a self-assessment return

Offence	Maximum Penalty
Late return	Immediate £100 fixed penalty
Return more than 3 months late	Daily fixed penalties of up to £10 per day for maximum 90 days
Return more than 6 months but less than 12 months late	Further tax geared penalty of 5% of tax due (minimum £300)
Return 12 months late	Further tax geared penalties apply (minimum £300): 100% if deliberate and concealed ⁽¹⁾ 70% if deliberate but not concealed ⁽¹⁾ 5% in all other cases

(1) These tax geared penalties are reduced for disclosure as per penalties for incorrect returns.

PAYE: penalties for late returns/ submissions

Number of employees	Monthly penalty
1 to 9	£100
10 to 49	£200
50 to 249	£300
250 or more	£400

If the form is more than three months late, an additional penalty is due of 5% of the tax and NIC that should have been reported.

Additionally, there is a £300 penalty per late P11D return, with an extra £60 per day charged if the delay continues.

PAYE: penalties for late payment

	No of late payments	% of tax unpaid ⁽¹⁾
	1st	nil
	2 nd , 3 rd & 4 th	1%
	5 th , 6 th & 7 th	2%
	8 th , 9 th & 10 th	3%
Penalties for late payment of in-year PAYE depend on the number of defaults in the tax year	11 th or more	4%
Where a penalty has been imposed and the tax remains unpaid at 6 months		5% ⁽²⁾
Where a penalty has been imposed and the tax		5% ⁽²⁾

remains unpaid at 12 months

(1) The percentage penalty is applied to the total amount that is late in the relevant tax month.

(2) The 6 month and the further 12 month penalties are in addition to the initial penalty for late payment.

VAT: penalties

Offence	Maximum Penalty
Failure to notify liability for registration or change in nature of supplies by person exempted from registration	See above: penalties for failure to notify

VAT: late payment or late filing - default surcharge

Default involving late payment of VAT in the surcharge period ⁽¹⁾	Surcharge as a percentage of the VAT outstanding at the due date
First	2% ⁽²⁾
Second	5% ⁽²⁾
Third	10% ⁽³⁾
Fourth	15% ⁽³⁾

(1) Default if late payment of VAT or filing of VAT return and surcharge liability notice issued, but default surcharge only applies on late payment.

(2) No surcharge if it would be less than £400.

(3) Minimum £30 payable.

VAT errors

An error made on a VAT return can be corrected on the next return provided it was not deliberate and does not exceed the greater of:

- £10,000 (net under-declaration minus over-declaration); or
- 1% x net VAT turnover for return period (maximum £50,000)

Alternatively, a 'small' error which is not deliberate may be corrected via the submission of form VAT652. Errors which are not 'small' or errors which are deliberate should be notified to HMRC on form VAT652.

RECORD KEEPING PENALTY

Offence	Maximum Penalty
Failure to keep and retain tax records	£3,000 per tax year / accounting period

INCOME TAX RATES: 2020/21

	Rate	Taxable income band
Main rates		
Basic rate	20%	£1 - £37,500
Higher rate	40%	£37,501 - £150,000
Additional rate	45%	Over £150,000
Savings rates		
Starting rate for savings	0%	£1 - £5,000
Savings income nil rate	0%	First £1,000 or £500
Savings basic rate	20%	Otherwise chargeable at basic rate

	Rate	Taxable income band
Savings higher rate	40%	Otherwise chargeable at higher rate
Savings additional rate	45%	Otherwise chargeable at additional rate
Dividends rates		
Dividend nil rate	0%	First £2,000
Dividend ordinary rate	7.5%	Otherwise chargeable at basic rate
Dividend upper rate	32.5%	Otherwise chargeable at higher rate
Dividend additional rate	38.1%	Otherwise chargeable at additional rate
Default rates		
Default basic rate	20%	
Default higher rate	40%	
Default additional rate	45%	
INCOME TAX RELIEFS		2020/21
Personal allowance		£12,500

CGT RATES

	2020/21
Gains falling within the remaining basic rate band	10%
Gains exceeding the basic rate band	20%

CORPORATION TAX RATES

	FY 2020
Tax rate	19%
Augmented profits limit for corporation tax payment dates – large companies	£1,500,000
Augmented profits limit for corporation tax payment dates – very large companies	£20,000,000

NATIONAL INSURANCE CONTRIBUTIONS

	2020/21		
NIC CLASS 1	Annual	Monthly	Weekly
Primary threshold (PT)	£9,500	£792	£183
Secondary threshold (ST)	£8,788	£732	£169
Upper earnings limit (UEL)	£50,000	£4,167	£962
Apprentice upper secondary threshold (AUST) for under 25s	£50,000	£4,167	£962
Upper secondary threshold (UST) for under 21s	£50,000	£4,167	£962

	2020/21		
	Annual	Monthly	Weekly
NIC CLASS 1			
Employment allowance (per year, per employer)	£4,000		
Class 1 Primary contributions on earnings between PT & UEL	12%		
Class 1 Primary contributions on earnings above UEL	2%		
Class 1 Secondary contributions on earnings above ST where employee aged 21 or over and not an apprentice under the age of 25	13.8%		
Class 1 Secondary contributions on earnings between ST & AUST for apprentices under the age of 25	0%		
Class 1 Secondary contributions on earnings above AUST for apprentices under the age of 25	13.8%		
Class 1 Secondary contributions on earnings between ST & UST for employees under the age of 21	0%		
Class 1 Secondary contributions on earnings above UST for employees under the age of 21	13.8%		
Class 1A contributions	13.8%		

	2020/21
NIC CLASS 2	
Normal rate	£3.05 pw
Small profits threshold	£6,475 pa
NIC CLASS 4	
Annual lower profits limit (LPL)	£9,500
Annual upper profits limit (UPL)	£50,000
Percentage rate between LPL & UPL	9%
Percentage rate above UPL	2%
VAT	
Standard rate of VAT	20%
Reduced rate of VAT	5%

Syllabus Area: Income Tax & NIC

INCOME TAX RATES: 2020/21	Rate	Taxable income band
Main rates		
Basic rate	20%	£1 - £37,500
Higher rate	40%	£37,501 - £150,000
Additional rate	45%	Over £150,000
Savings rates		

INCOME TAX RATES: 2020/21	Rate	Taxable income band
Starting rate for savings	0%	£1 - £5,000
Savings income nil rate	0%	First £1,000 or £500
Savings basic rate	20%	Otherwise chargeable at basic rate
Savings higher rate	40%	Otherwise chargeable at higher rate
Savings additional rate	45%	Otherwise chargeable at additional rate
Dividends rates		
Dividend nil rate	0%	First £2,000
Dividend ordinary rate	7.5%	Otherwise chargeable at basic rate
Dividend upper rate	32.5%	Otherwise chargeable at higher rate
Dividend additional rate	38.1%	Otherwise chargeable at additional rate
Default rates		
Default basic rate	20%	
Default higher rate	40%	
Default additional rate	45%	

INCOME TAX RELIEFS	2020/21
Personal allowance ⁽¹⁾	£12,500
Marriage allowance ⁽²⁾	£1,250

(1) The personal allowance of any individual with adjusted net income above £100,000 is reduced by £1 for every £2 of adjusted net income above the £100,000 limit.

(2) A spouse or civil partner who is a basic rate taxpayer or who has income of less than the personal allowance is allowed to transfer £1,250 of their personal allowance (ie 10% rounded up to the next £10) to their spouse/civil partner provided the recipient spouse is a basic rate taxpayer.

CAPITAL ALLOWANCES

First year allowances available

100% on new and unused zero emissions goods vehicles

100% on new and unused low emission cars ie electrically propelled or with CO₂ emissions of not more than 50 g/km

100% on electric vehicle charging points

Annual investment allowance

£200,000 pa of expenditure incurred by any business on certain plant and machinery from 1 January 2021.

Writing down allowances

18% pa in the main pool

COMPANY VANS, CARS AND FUEL

Van scale charge

No charge applies if there is insignificant private use

£2,792 if van has zero CO₂ emissions and £3,490 if it has CO₂ emissions

Additional £666 if private fuel provided for the van

Company cars - cash equivalent

Zero emissions cars 0% of list price

Company cars - cash equivalent

	2% of list price for cars with a battery range of >130 miles
	5% of list price for cars with a battery range of 70-129 miles
	8% of list price for cars with a battery range of 40-69 miles
Hybrid cars with emissions 1-50g/km	12% of list price for cars with a battery range of 30-39 miles
	14% of list price for cars with a battery range of <30 miles
Other cars	15% of list price for cars emitting 51-54g/km
	16% of list price for cars emitting 55-59g/km
	17% of list price for cars emitting 60-64g/km
	18% of list price for cars emitting 65-69g/km
	19% of list price for cars emitting 70-74g/km
	20% of list price for cars emitting 75-79g/km
	Increased by 1% per 5g/km over the 75g/km relevant threshold

Relevant % is reduced by 2% for cars first registered from 6 April 2020

Capped at 37% of list price (ie emissions of 160g/km or more for cars first registered before 6 April 2020 and 170g/km for cars first registered from 6 April 2020)

Diesel cars that meet the Real Driving Emissions Step 2 (RDE2) standard are treated as above, all other diesel cars have a 4% supplement added to the relevant percentage (subject to 37% cap)

Private fuel provided for company car

£24,500 x company car %

PAYE CODES

L	tax code with personal allowance
M	tax code with personal allowance plus claiming marriage allowance
N	tax code with personal allowance less surrendered marriage allowance
S	income taxed at Scottish rate of income tax
C	income taxed at Welsh rate of income tax
K	total allowances are less than total deductions
T	tax code includes other calculations to work the personal allowance, for example it has been reduced because estimated annual income is more than £100,000

NATIONAL INSURANCE CONTRIBUTIONS

NIC CLASS 1 CONTRIBUTIONS	2020/21		
	Ann ual	Mon thly	We ekly
Primary threshold (PT)	£9,500	£792	£183
Secondary threshold (ST)	£8,788	£732	£169
Upper earnings limit (UEL)	£50,000	£4,167	£962

	2020/21		
NIC CLASS 1 CONTRIBUTIONS	Ann ual	Mon thly	We ekly
Apprentice upper secondary threshold (AUST) for under 25s	£50,000	£4,167	£962
Upper secondary threshold (UST) for under 21s	£50,000	£4,167	£962
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Class 1 Primary contributions on earnings between PT & UEL	12%		
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Class 1 Secondary contributions on earnings above AUST for apprentices under the age of 25	13.8%		
Class 1 Secondary contributions on earnings between ST & UST for employees under the age of 21	0%		
Class 1 Secondary contributions on earnings above UST for employees under the age of 21	13.8%		
Class 1A contributions	13.8%		

	2020/21
NIC CLASS 2 CONTRIBUTIONS	
Normal rate	£3.05 pw
Small profits threshold	£6,475 pa
NIC CLASS 4 CONTRIBUTIONS	
Annual lower profits limit (LPL)	£9,500
Annual upper profits limit (UPL)	£50,000
Percentage rate between LPL & UPL	9%
Percentage rate above UPL	2%

Syllabus area: Capital Gains

	2020/21
Annual exempt amount	£12,300
Gains falling within the remaining basic rate band	10%
Gains exceeding the basic rate band	20%
Basic rate band	£1 – £37,500

Syllabus area: Corporation tax

FY 2020

Tax rate	19%
Augmented profits limit for corporation tax payment dates – large companies	£1,500,000
Augmented profits limit for corporation tax payment dates – very large companies	£20,000,000

CAPITAL ALLOWANCES

First year allowances available

- 100% on new and unused zero emissions goods vehicles
- 100% on new and unused low emission cars ie electrically propelled or with CO₂ emissions of not more than 50 g/km
- 100% on electric vehicle charging points

Annual investment allowance

£200,000 pa of expenditure incurred by any business on certain plant and machinery from 1 January 2021.

Writing down allowances

18% pa in the main pool

PAYMENT DATES

Payment dates for corporation tax

Corporation tax	Nine months and one day after the end of an accounting period
Corporation tax by instalments – large companies	The 14 th day of months 7, 10, 13 and 16 counted from the start of a 12-month accounting period
Corporation tax by instalments – very large companies	The 14 th day of months 3, 6, 9 and 12 counted from the start of a 12-month accounting period

Syllabus area: Value Added Tax

VAT

Standard rate		20%
Reduced rate		5%
Annual registration limit	From 1 April 2017	£85,000
Deregistration limit	From 1 April 2017	£83,000
VAT fraction (standard rated)		1/6

Cash accounting	£
Turnover threshold to join scheme	1,350,000
Turnover threshold to leave scheme	1,600,000
Annual accounting	
Turnover threshold to join scheme	1,350,000
Turnover threshold to leave scheme	1,600,000

Flat rate scheme	
Annual taxable turnover limit (excluding VAT) to join scheme	150,000
Annual total income (including VAT) to leave scheme	230,000



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